LIBRARY
SUPREME COURT, U.S.

Supreme Court, U.S.
FILED
DEC 24 1970
E. ROBERT SEAVER, CLERK

IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. ~~1159~~ 70-60

Superintendent of Insurance of the State of New York, as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner,

—against—

BANKERS LIFE AND CASUALTY COMPANY,
IRVING TRUST COMPANY,
BELGIAN AMERICAN BANKING CORPORATION,
BELGIAN AMERICAN BANK & TRUST COMPANY,
GARVIN, BANTEL & COMPANY,
GEORGE K. GARVIN,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

ARNOLD BAUMAN
Attorney for Petitioner
45 Rockefeller Plaza
New York, N. Y. 10020
Tel. 246-8380

Of Counsel:
PHILIP M. KAZIN

INDEX

PAGE

Table of Authorities iii

Opinions Below 2

Jurisdiction 2

Questions Presented 2

Statutes and Regulations Involved 3

Statement of the Case 5

A. Basis for Federal Jurisdiction 5

B. Procedural History 5

C. The Facts 7

1. Sale of Manhattan Stock 7

2. Events subsequent to January 24, 1962 9

REASONS FOR GRANTING WRIT—

I. The Court below erred in affirming the dismissal of the complaint where the record disclosed that a board of directors was fraudulently induced to authorize the sale of securities owned by a corporation and the proceeds of such sale were diverted from the corporation 13

A. Section 10(b) and Rule 10b-5 are violated when a board of directors is fraudulently induced to authorize the sale of securities of a corporation 14

PAGE

B. Section 10(b) and Rule 10b-5 are violated when the proceeds from a sale of securities are misappropriated 18

II. The decision appealed from conflicts with the decision of the Court of Appeals for the Fifth Circuit in *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (1960) 21

III. The purchaser-seller restriction enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952) cert. denied, 343 U.S. 956 (1952) should be abolished 22

IV. The Court of Appeals, in holding that Petitioner has not alleged a federal cause of action in connection with the transactions in certificates of deposit, has ruled erroneously on an important question of securities law that has not been but should be decided by the Supreme Court 24

CONCLUSION 26

APPENDIX A 1a

APPENDIX B 15a

APPENDIX C 16a

APPENDIX D 17a

APPENDIX E 57a

Table of Authorities

PAGE

Cases:

A. T. Brod & Co. v. *Perlow,* 375 F.2d 393 (2d Cir. 1967) 16
Allico Nat'l Corp. v. *Amalgamated Meat Cutters,* 397 F.2d 727 (7th Cir. 1968) 19

Birnbaum v. *Newport Steel Corp.,* 193 F.2d 461 (2d Cir. 1952) cert. denied, 343 U.S. 956 (1952) 3, 22

Cooper v. *North Jersey Trust Co.,* 226 F. Supp. 972 (S.D.N.Y. 1964) 19
Crane Co. v. *Westinghouse Air Brake Co.,* 419 F.2d 787 (2d Cir. 1969) cert. denied, 91 S.Ct. 41 (1970) 16

Dasho v. *Susquehanna Corp.,* 380 F.2d 262 (7th Cir. 1967) cert. denied sub nom. *Bard* v. *Dasho,* 389 U.S. 977, 88 S.Ct. 480 (1967) 18
Dauphin Corp. v. *Sentinel Alarm Corp.,* 206 F. Supp. 432 (D. Del. 1962) 18

Globus Inc. v. *Jaroff,* 266 F. Supp. 524 (S.D.N.Y. 1967) 14, 18
Goodman v. *Hentz & Co.,* 265 F. Supp. 440 (N.D. Ill. 1967) 15
Greenstein v. *Paul,* 400 F.2d 580 (2d Cir. 1968) 22, 23

Herpich v. *Wallace,* 430 F.2d 792 (5th Cir. 1970) 20
Hooper v. *Mountain States Securities Corp.,* 282 F.2d 195 (5th Cir. 1960) cert. denied, 365 U.S. 814, 81 S.Ct. 695 (1961) 3, 21, 22
Hoover v. *Allen,* 241 F. Supp. 213 (S.D.N.Y. 1965) 21

In re Calvert, 35 S.E.C. 141 (1953) 19
In re Lockaby, 29 S.E.C. 271 (1949) 19

PAGE

Kane v. *Central American Mining & Oil, Inc.*, 235 F. Supp. 559 (S.D.N.Y. 1964) 20

Mills v. *Electric Autolite Co.*, 396 U.S. 375, 90 S.Ct. 616 (1970) 14, 15, 16

New Park Mining Co. v. *Cranmer*, 225 F. Supp. 261 (S.D.N.Y. 1963) 20

O'Neill v. *Maytag*, 230 F. Supp. 235 (S.D.N.Y. 1964) 18

Pacific Insurance Co. v. *Blot*, 267 F. Supp. 956 (S.D. N.Y. 1967) 22

Parker v. *Baltimore Paint & Chemical Corp.*, 244 F. Supp. 267 (D. Col. 1965) 19

Puharich v. *Borders Electronics Co.*, CCH FED. SEC. L. REP. ¶ 92.141 (S.D.N.Y. 1968) 15, 18

Ruckle v. *Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964) 14, 18

SEC v. *National Securities*, 393 U.S. 453, 89 S.Ct. 564 (1969) 24

SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (en banc), cert. denied sub nom. *Coates* v. *SEC*, 394 U.S. 976, 89 S.Ct. 1454 (1969) 17

Simon v. *New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966) 14, 21

Stockwell v. *Reynolds*, 252 F. Supp. 215 (S.D.N.Y. 1965) 22

Superintendent of Insurance v. *Bankers Life and Casualty Co.*, 300 F. Supp. 1083 (S.D.N.Y. 1969), aff'd 430 F.2d 355 (2d Cir. 1970) 2, 13, 20

PAGE

United States v. *Robertson*, 181 F. Supp. 158 (S.D.N.Y. 1959) aff'd., 298 F.2d 739 (2d Cir. 1962) 19

Vine v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967) cert. denied, 389 U.S. 970, 89 S.Ct. 463 (1967) 22

Statutes and Regulations:

Securities Act of 1933, Section 17(a), 15 U.S.C. § 77q(a) 3, 4

Securities Act of 1933, Section 22, 15 U.S.C. § 77v 5

Securities Exchange Act of 1934, Section 10(b), 15 U.S.C. § 78j(b) 3, 4, 20, 22, 24, 25, 26

Securities Exchange Act of 1934, Section 14(a), 15 U.S.C. § 78n 16

Securities Exchange Act of 1934, Section 27, 15 U.S.C. § 78aa 5

28 U.S.C. § 1254(1) 2

Rule 10b-5 of The Securities and Exchange Commission, 17 CFR Section 240.10(b)(5) 3, 4, 13, 16, 18, 20, 22, 24, 25, 26

IN THE

Supreme Court of the United States

OCTOBER TERM, 1970

No. .....

Superintendent of Insurance of the State of New York,
as Liquidator of MANHATTAN CASUALTY COMPANY,

Petitioner,

—against—

BANKERS LIFE AND CASUALTY COMPANY,
IRVING TRUST COMPANY,
BELGIAN AMERICAN BANKING CORPORATION,
BELGIAN AMERICAN BANK & TRUST COMPANY,
GARVIN, BANTEL & COMPANY,
GEORGE K. GARVIN,

Respondents.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

Petitioner the Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company prays that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Second Circuit entered in this case on July 22, 1970. Petitioner's motion for rehearing and rehearing en banc was denied by orders dated September 30, 1970.

Opinions Below

The opinion of the Court of Appeals for the Second Circuit, 430 F.2d 355 (1970) is annexed and appears at pages 1a-14a of Appendix A.* The opinions of the District Court for the Southern District of New York, 300 F. Supp. 1083 (S.D.N.Y. 1969) are annexed and appear at App. D, p. 17a and App. E, p. 57a.

Jurisdiction

The judgment of the Court of Appeals sought to be reviewed was entered on July 22, 1970. The petition for rehearing and rehearing en banc was denied by orders dated September 30, 1970, App. B, p. 15a; App. C, p. 16a. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

Questions Presented

1. Did the Court below err in affirming the dismissal of the complaint where the record disclosed that a board of directors was fraudulently induced to authorize the sale of securities owned by a corporation and the proceeds of such sale were wrongfully diverted from the corporation?

2. Are Rule 10b-5 and Section 10(b) violated where full value is paid by a purchaser of securities and the proceeds are immediately misappropriated by corporate seller's management and others as part of a fraudulent scheme to loot the corporation of its assets?

3. Does the decision appealed from conflict with the decision of the Court of Appeals for the Fifth Circuit in

---

* Citations to appendix hereinafter will appear, "App. A., p. ——", "App. B., p. ——."

Hooper v. *Mountain States Securities Corp.*, 282 F.2d 195 (1960)?

4. Should the strict purchaser-seller limitations enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952) cert. denied, 343 U.S. 956 (1952) be abolished?

5. Has the Court of Appeals, in holding that Petitioner has not alleged a federal cause of action in connection with the transactions involving certificates of deposit, ruled erroneously on an important question of securities law that has not been but should be decided by the Supreme Court?

Statutes and Regulations Involved

This is an action for damages based on violations of section 17(a) of the Securities Act of 1933, hereinafter the Securities Act, 15 U.S.C. section 77q(a), 3 United States Code at 2658 (1964 edition), and section 10(b) of the Securities Exchange Act of 1934, hereinafter the Exchange Act, 15 U.S.C. section 78j(b), 3 United States Code at 2698 (1964 edition), together with Rule 10b-5, 17 CFR section 240.10(b)(5) at 296 (revised as of Jan. 1, 1970), promulgated thereunder.

Section 17(a) of the Securities Act states:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme, or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission

to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Section 10(b) of the Exchange Act states:

"Section 10 It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

Statement of the Case

A. Basis for Federal Jurisdiction

Federal jurisdiction in the court of first instance is based on sections 77v, 78aa of Title 15, United States Code. Section 77v in part states:

"(a) The district courts of the United States, . . ., shall have jurisdiction of offenses and violations under this subchapter and under the rules and regulations promulgated by the Commission in respect thereto, and, concurrent with State and Territorial courts, of all suits in equity and actions at law brought to enforce any liability or duty created by this subchapter."

Section 78aa states in part:

"The district courts of the United States, . . ., shall have exclusive jurisdiction of violations of this chapter or the rules and regulations thereunder, and of all suits in equity and actions at law brought to enforce any liability or duty created by this chapter or the rules and regulations thereunder."

B. Procedural History

In May, 1963, the Superintendent of Insurance of the State of New York (Petitioner) was appointed Liquidator of Manhattan Casualty Company (Manhattan) by order of the New York State Supreme Court (Sup. Ct., N.Y.

Co., Index No. 40931/1963). That order vested Petitioner with all the rights of action of Manhattan. In that capacity, Petitioner commenced this action in August, 1963. The Petitioner was not a party to the transactions complained of, nor did he possess first hand knowledge of the events in question. The complaint was drawn on the basis of facts disclosed at hearings held by the Insurance Department of the State of New York in connection with proceedings which led to the liquidation of Manhattan.

After six and one half years of extensive discovery, yielding approximately 12,000 pages of testimony and 500 documents marked for identification, additional facts foreshadowed by the allegations in the complaint have come to light and are included in the record.

The Note of Issue was filed on August 31, 1967. On April 17, 1968, defendant Bankers Life and Casualty Company (Bankers Life) moved in the United States District Court for the Southern District of New York for summary judgment. Judge Sylvester J. Ryan denied that motion without prejudice, and suggested that the questions of subject matter jurisdiction and Petitioner's standing to sue be reached *in limine*.

Accordingly, Bankers Life, defendant Belgian American Banking Corporation (Belgian Banking) and Belgian American Bank and Trust Company (Belgian Trust) moved to dismiss this action pursuant to Rules 12(c) and 12(h) of the Federal Rules of Civil Procedure before the late Judge William B. Herlands. Defendants Irving Trust Company (Irving Trust), Garvin Bantel & Company (Garvin, Bantel) and George K. Garvin (Garvin) made identical motions before Judge Ryan. Both motions were granted by judgments entered on June 4, 1969 and June 17, 1969, respectively.

Petitioner appealed and on July 22, 1970, the United States Court of Appeals for the Second Circuit affirmed the judgments of the District Court. Judge Hays dissented. Although the majority opinion found as did Judge Herlands, that a fraud had been committed, the Court held that Petitioner had failed to allege a claim for relief under the federal securities acts. It is from this judgment that Petitioner seeks certiorari.

C. The Facts

1. *Sale of Manhattan Stock.*

Manhattan was the victim of a fraudulent scheme whereby it was purchased with and looted of its assets. Until January 24, 1962, Bankers Life was the sole stockholder of Manhattan. The fraudulent scheme is reflected in the following events. On that day, Bankers Life sold its stock in Manhattan for $5,000,000 to a purchasing group which included Standish T. Bourne (Bourne) and James F. Begole (Begole). Bourne and Begole arranged in advance with Irving Trust that it would issue its check for $5,000,000 in payment of the purchase price to Bankers Life. On January 24, 1962, Irving Trust sent an officer with a check for $5,000,000 to attend the closing of the sale of the stock. At that closing he delivered the check made payable to Bankers Life as the purchase price for Manhattan stock. At this point in time, Manhattan did not maintain an account at Irving Trust. Shortly after the closing, the entire Manhattan portfolio of government securities totaling almost $5,000,000 was sold to Second District Securities which delivered a check in the amount of $4,854,552.67 representing the proceeds of the sale to Irving Trust. Manhattan transferred cash to Irving to bring the total to $5,000,000. Irving Trust promptly applied the proceeds against the $5,000,000 check it had delivered to Bankers

Life earlier that morning. These transactions, as well as those of the afternoon of January 24, 1962, were conceived by Garvin, a general partner in the note brokerage firm of Garvin, Bantel.

The perpetrators deceived Manhattan's board of directors into voting approval for the sale of Manhattan's portfolio of United States Government Bonds by representing that the proceeds would be used to purchase a certificate of deposit (CD).* In short, Manhattan sold assets worth almost $5,000,000 as a result of the deception of its board of directors and received nothing in return.

In order to conceal the depletion of $5,000,000 of assets and Manhattan's resultant insolvency, a paper asset had to be created. As part of the scheme, Garvin and Garvin, Bantel had arranged in advance for a check swap to take place among three financial institutions on that very afternoon. Irving Trust issued a $5,000,000 check in the name of Manhattan which was tendered to Belgian Trust. Belgian Trust then issued a $5,000,000 CD in the name of Manhattan. John F. Sweeny (Sweeny), newly installed as President of Manhattan after its sale that morning, endorsed the CD over to New England Note Corporation (New England Note), a company controlled by Bourne. Bourne then endorsed the CD over to Belgian Banking, which used the CD as collateral for a so-called $5,000,000 loan to New England Note. A Belgian Banking check for $5,000,000 representing the New England Note loan was immediately given to Irving Trust to repay it for its check to Belgian Trust. Thus an asset in identical amount to that of which Manhattan was defrauded was created in its name and

---

* See pages 97a-101a of the Appendix to Petitioner's main brief in the United States Court of Appeals. Said Appendix was certified and transmitted to the Supreme Court by the Clerk of the Court of Appeals for the Second Circuit.

carried on its books as cash without reference to its total hypothecation, for the sole purpose of concealment.

Belgian Banking made a second loan to New England Note in the amount of $250,000 which was distributed in part as follows: Belgian Banking $100,000, Bourne $50,000, Begole $50,000, and Garvin, Bantel $25,000.

At the close of January 24, 1962, ownership of the shares of Manhattan had been transferred. Irving Trust had issued two $5,000,000 checks. It was reimbursed in full for the first from the assets of Manhattan. It was reimbursed in full for the second by the check of Belgian Banking representing the proceeds from the so-called loan to New England Note for which a CD in the name of Manhattan served as collateral.

During this period, Manhattan had no account at Irving Trust. In order to conceal the transactions, Irving made a series of false entries on its books. These entries were supported by backdated letters obtained for Irving by Garvin from Bourne. The acts described above were all part of one fraudulent scheme designed to gain control of Manhattan by using its assets to meet the purchase price.

2. *Events subsequent to January 24, 1962.*

On July 24, 1962, the CD and the alleged loans made by Belgian Banking and Belgian Trust to New England Note matured. To continue to conceal the depletion of Manhattan's assets, Bourne, Garvin and Garvin, Bantel, Begole, Belgian Banking and Belgian Trust arranged to renew the loans and to issue a new CD to be held as collateral in the manner of January 24, 1962. However, at this point Sweeny, the President of Manhattan and a member of its board, now fearful, objected to the fact that the certificate was to be hypothecated. The other named defendants therefore mis-

represented to him and consequently to Manhattan whose agent he was, that the certificate to be issued would not be held as collateral and that the stock of Manhattan would be the sole collateral for the loans to New England Note. In fact it was arranged for Begole to issue a letter to Belgian Trust and Belgian Bank indicating that the new CD was being held as collateral for the loans, which he did and Belgian Bank so held it thereafter. Thus Sweeny was induced through fraud to purchase a new CD which was rendered valueless to Manhattan by the acts of the schemers. The schemers made it appear that Belgian Trust owed $5,000,000 plus interest to Manhattan evidenced by the new CD, that Manhattan further had on deposit at Belgian Trust a sum in excess of $5,000,000 and New England Note owed Belgian Banking $5,250,000.

Since Sweeny insisted on keeping physical possession of the new certificate to display as the need might arise, Belgian Trust, to further conceal the true facts, issued another CD covering the same funds so that Belgian Bank might retain one to display to Bank Examiners as collateral for the renewed loan.

Furthermore, in August 1962 Belgian Trust and Belgian Banking contrived to have Sweeny return the CD that had been given to him in July and to endorse a negotiable certificate in Manhattan's name. To accomplish this the Bank official signed a letter falsely representing that the CD issued in July was being held in trust by Belgian Trust for Manhattan, whereas in fact Belgian Trust agreed to sign this letter to obtain Sweeny's endorsement of the CD. Thereafter, Belgian Banking held the CD as collateral for the loan to New England Note under the letter of instructions issued by Begole without authorization from Manhattan. The endorsement of the July CD rendered it valueless to Manhattan. Sweeny's signature as Treasurer of

Manhattan (an office he then held) was necessary to effect the collateralization and he was induced to sign only after it had been misrepresented to him that the certificate was to be held in trust and not as collateral. Sweeny, however, endorsed the certificate in his capacity as President of Manhattan which was ineffective to establish a collateralization. This was subsequently changed to "Treasurer" by another hand after the certificate was in the possession of Belgian Banking.

In August, 1962, Manhattan transmitted a CD for $500,000 drawn on the First National Bank of Boston which it owned free of all encumbrances, to Belgian Trust to be held in trust for safekeeping. However, in January 1963 the Belgian Trust CD matured and the loans (in the amount of $5,000,000 and $250,000 to New England Note and Bourne, respectively) fell due. Therefore, to continue to conceal the depletion of Manhattan's assets another series of misrepresentations was made which also resulted in the loss of this asset to Manhattan. The original plan was to effect a direct pair-off of the $5,000,000 CD against the $5,000,000 loan and to use the $500,000 CD to pay the interest on the $5,000,000 loan. The $250,000 loan was to be shipped to Boston together with the stock of Manhattan to be held by the Boston financial institution as collateral. However, this plan was discovered and thwarted by Sweeny.

Bourne, Garvin and Garvin, Bantel, Belgian Trust, Belgian Banking, Irving Trust and Begole then conspired to effect the pair-off of CD's against the loans to New England Note in the following manner. It was misrepresented to Sweeny and Manhattan that Irving Trust would issue $5,500,000 worth of CD's for the account of Manhattan and that the loans for which the Belgian Trust certificates were being held as collateral were to be refinanced. Sweeny was told to instruct Belgian Trust to deliver the

proceeds of those CD's to Irving Trust to effect payment for the new CD's to be issued by Irving Trust for Manhattan. Relying on this misrepresentation, Sweeny instructed Belgian Trust to pay the proceeds to Irving Trust. In fact, Garvin had arranged for his clearance bank, Marine Midland, to effect payment on $5,500,000 bearer certificates, which it did, and Irving Trust transmitted such certificate to Marine Midland. There they were held as collateral for the loan to Garvin by which payment was effected. Garvin then caused Irving Trust to issue a check payable to Belgian Banking in the amount of $5,250,000, presumably to pay off the loans to New England Note. However, this was nothing more than a check swap between Irving Trust, Belgian Banking, and Belgian Trust employed to make it appear that outside monies had been used to pay off the loans. Upon receipt of the Irving Trust check in the amount of $5,250,000, Belgian Trust drew a check payable to Irving Trust in the amount of $5,500,000 which represented the proceeds of the two CD's (exclusive of interest which was paid into Manhattan's account) which were now held free and clear for Manhattan since the loans for which they had been held as collateral had been paid by the Irving Trust check. This check was supposed to be released to Irving Trust to effect payment on the Irving Trust CD's pursuant to Manhattan's letter of instruction signed by Sweeny to Belgian Trust. When Irving Trust received this money, instead of crediting it to Manhattan's account it was used to offset the $5,250,000 check it had issued at Garvin's request payable to Belgian Banking and both checks were passed through the account of Garvin, Bantel.

REASONS FOR GRANTING WRIT

I.

The Court below erred in affirming the dismissal of the complaint where the record disclosed that a board of directors was fraudulently induced to authorize the sale of securities owned by a corporation and the proceeds of such sale were diverted from the corporation.

That Manhattan was the victim of a fraud was recognized both by the District Court and the Court of Appeals. Judge Herlands stated:

> "The complaint in this case presents no more than a complicated scheme of common law fraud." (App. D, p. 56a).

The majority opinion of the Court of Appeals stated:

> "What distinguishes the fraud perpetrated on Manhattan in this case from . . ." (App. A, p. 9a).
>
> • • •
>
> "No doubt the deception was successful, for had the board known that Sweeny and his associates intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale." (App. A, p. 10a).

The only issue to be resolved is whether or not the fraud perpetrated on Manhattan is one which is federally cognizable.

Although some facts presented in support of the claim on appeal do not appear in the complaint, the Court of Appeals properly considered them. *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 430 F.2d 355, 360

(2d Cir. 1970). The Court below rejected jurisdiction under Rule 10b-5 on the grounds that neither the purchaser nor the seller of Manhattan's bonds was deceived or defrauded with respect to the terms of the sale itself and further, that the only fraud which harmed plaintiff was the failure of the perpetrators to account for the proceeds.

A. Section 10(b) and Rule 10b-5 are violated when a board of directors is fraudulently induced to authorize the sale of securities of a corporation.

The Court recognized that the board of directors of Manhattan was induced by misrepresentations to approve the sale of bonds. The Court held, however, that since the board was deceived as to the misappropriation of the proceeds from the sale and not as to the terms of the sale (value of the bonds or the consideration paid for them), there was no violation of Rule 10b-5. The three cases cited in support of this distinction are *Ruckle* v. *Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964); *Globus Inc.* v. *Jaroff*, 266 F. Supp. 524 (S.D.N.Y. 1967); and *Simon* v. *New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966). Each one of them upheld 10b-5 jurisdiction where the board of directors or shareholders were induced by misrepresentations of investment value into approving a sale or purchase of securities. However, there is no language in any of these decisions that limits federal jurisdiction to misrepresentations of investment value. Where it is alleged that a corporation has been defrauded into selling securities because the approval necessary for the transaction was induced by material misrepresentations of any kind, federal jurisdiction exists. Since this principle controls where the misrepresentations or omissions of material fact concern such things as the financial condition of a compeny, e.g., *Ruckle, supra; Simon, supra;* certainly where the falsehoods involved are far more outrageous in

that they conceal or fail to disclose that the seller will receive nothing for the asset it is deceived into surrendering, jurisdiction must also exist. See, *Puharich* v. *Borders Electronics Co.*, CCH FED. SEC. L. REP. ¶ 92.141 (S.D.N.Y. 1968); *Goodman* v. *Hentz & Co.*, 265 F. Supp. 440 (N.D. Ill. 1967). In *Goodman, supra* at 444-445, the Court stated:

> "The fact that the fraud was so substantial that entire transactions intended by plaintiffs to be purchases and sales for their accounts, amounted to complete conversions of their funds by Rubloff, does not deprive plaintiffs of their right to recover under the Securities Act, a right they clearly would have if Rubloff had perpetrated lesser frauds, such as misrepresentations concerning quality of stocks he recommended to them [citation omitted]; . . . . If there is any difference between the fraud in these cases and the fraud in the case at bar, it is only that the latter is more odious, because the customer loses his entire investment."

Not one cited authority indicates that jurisdiction should be denied, as did the Court below in the instant matter, if the misrepresentations inducing the transaction did not concern the terms of the sale. In fact, the judgment appealed from represents the first time a federal court has so limited the scope of Rule 10b-5. This Court has held that in the fraudulent solicitation of proxies, the fact that the misrepresentation had nothing to do with the terms of the sale or that the sale itself was fair is irrelevant for purposes of determining whether plaintiff has stated a federal cause of action. *Mills* v. *Electric Autolite Co.*, 396 U.S. 375, 90 S. Ct. 616 (1970). There, this Court stated, at 90 S. Ct. 620:

> "The result [of permitting all liability to be foreclosed on the basis of a finding that the transaction was fair] would be to insulate from private redress an entire category of proxy violations—those relating to matters other than the terms of the merger. Even outrageous misrepresentations in a proxy solicitation, if they did not relate to the terms of the transaction, would give rise to no cause of action under § 14(a). Particularly if carried over to enforcement actions by the Securities and Exchange Commission itself, such a result would subvert the congressional purpose of ensuring full and fair disclosure to shareholders."

Although *Mills, supra,* concerned proxy solicitations under section 14(a) of the Exchange Act, the same reasoning should control in Rule 10b-5 actions, especially in view of the Courts' traditional broad construction of the statutory phrase "in connection with the purchase or sale of any security." *Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 789 & N. 14 (2d Cir. 1969) cert. denied, 91 S. Ct. 41 (1970). To hold otherwise would insulate from private redress that entire category of misrepresentations relating to matters other than the terms of the sale—a result that this Court has already rejected. *Mills* v. *Electric Autolite Co., supra.*

In applying the "terms of the sale test", the Court conflicted with its earlier decision in *A. T. Brod & Co.* v. *Perlow,* 375 F. 2d 393 (2d Cir. 1967). There, the Court held, at 375 F. 2d 396-397:

> "Neither § 10(b) nor Rule 10b-5 contains any language which would indicate that those provisions were intended to deal only with fraud as to the investment value of securities, and, indeed, it is established that a

> 10b-5 action will survive even though the fraudulent scheme or device is unrelated to investment value. . . . Nor do we think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities.' We believe that § 10(b) and Rule 10b-5 prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws."

Nor can it be contended that the fraud perpetrated on the board of directors was not "in connection" with a securities transaction. It has been held that a fraud is "in connection" with a securities transaction where:

> "... the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities."

SEC v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 860 (2d Cir. 1968) (en banc), cert. denied sub nom. *Coates* v. *SEC*, 394 U.S. 976, 89 S. Ct. 1454 (1969).

The perpetrators of the fraud recognized that in order to obtain the funds necessary to pay Bankers Life for the stock of Manhattan, the board of directors would be required to authorize the sale of bonds owned by Manhattan. These bonds were ultimately the source of funds with which Manhattan was purchased. Without the sale of the bonds (the securities transaction) there would be no acquisition; without the fraud (deception of the board) there would be no sale of bonds.

There is no logic in separating the deception of the board from the sale of securities it authorized. Indeed, the Court below accepted the fact that had the board not been deceived, it would not have authorized the sale of securities. *Supra* at 13. By limiting a federally cognizable fraud to one involving the terms of sale, the Court below has too narrowly construed the anti-fraud provisions of Rule 10b-5.

It cannot be doubted that the conduct alleged here, apart from the subsequent misappropriation of proceeds, amounting to

> "... either fraud or deceit i.e. intentional misrepresentation of facts, or to an untrue statement of material fact, or an omission to state a material fact ..." *O'Neill* v. *Maytag,* 230 F. Supp. 235, 239 (S.D.N.Y. 1964)

is a federal cognizable fraud. Although the misappropriation of the proceeds was the object of the scheme, the device used to dislodge the assets from their rightful ownership was fraud in the nature of deceit, practiced upon the decision-making body of the corporation inducing a sale of securities. This allegation of federal fraud was sufficient to defeat a motion to dismiss the complaint. See, e.g. *Ruckle, supra, Dasho* v. *Susquehanna Corp.,* 380 F.2d 262 (7th Cir. 1967) cert. denied sub nom. *Bard* v. *Dasho,* 389 U.S. 977, 88 S. Ct. 480 (1967); *Globus, supra; Dauphin Corp.* v. *Sentinel Alarm Corp.,* 206 F. Supp. 432 (D. Del. 1962).

B. Section 10(b) and Rule 10b-5 are violated when the proceeds from a sale of securities are misappropriated.

Assuming, arguendo, that the board was not induced by misrepresentations into authorizing the sale of bonds, the mere fraudulent deprivation from the seller of the consideration bargained for, even when committed by corporate insiders, is a violation of Rule 10b-5. *Puharich* v.

Borders Electronics Co., supra; Parker v. *Baltimore Paint & Chemical Corp.*, 244 F. Supp. 267 (D. Col. 1965). In *Parker, supra,* the Court noted that acts amounting to corporate mismanagement, namely, conversion of the sale price, were fraudulent acts in connection with the earlier sale of securities which in itself was pure. Thus, if the sale of bonds was not fraudulently induced, and if the proceeds from the sale were paid into Manhattan's account (assuming for the moment that Manhattan had an account), and the proceeds were then converted by corporate insiders pursuant to the scheme to pay Irving Trust for the check to Bankers Life, a violation of Rule 10b-5 would still exist. See, *Cooper* v. *North Jersey Trust Co.*, 226 F. Supp. 972 (S.D.N.Y. 1964); *United States* v. *Robertson,* 181 F. Supp. 158 (S.D.N.Y. 1959); aff'd., 298 F.2d 739 (2d Cir. 1962); *In re Calvert,* 35 S.E.C. 141 (1953); *In re Lockaby,* 29 S.E.C. 271 (1949). See also: *Allico Nat'l Corp.* v. *Amalgamated Meat Cutters,* 397 F.2d 727 (7th Cir. 1968).

The Court of Appeals found that the only fraud harmful to Manhattan was in the failure of the schemers to account for the proceeds of the sale. The Court, however, disregarded the plain fact that each fraudulent act including the misappropriation of the proceeds by defendants was a vital part of one scheme and the successful perpetration of the scheme damaged the corporation to the extent of $5,000,000. The Court below has severed the mismanagement of Manhattan from the sale of bonds and held that the mismanagement allegations standing alone do not constitute a 10b-5 case. The Court, however, is

> "not at liberty to disregard [Petitioner's] allegations and to now hold that the charges are unrelated." *Parker* v. *Baltimore Paint & Chemical Corp.*, 244 F. Supp. 267, 270 (D. Col. 1965).

As the District Court recognized:

> "The direct involvement of the deceit with a transaction in securities is fraud 'in connection with' the sale of the stock, and consequently constitutes federal fraud irrespective of whether it also constitutes corporate mismanagement." *Superintendent of Insurance* v. *Bankers Life and Casualty Co.*, 300 F. Supp. 1083, 1102-1103 (S.D.N.Y. 1969).

Violators of Rule 10b-5 are not immunized from civil liability for their unlawful acts merely because those acts were committed as part of a broader scheme of corporate mismanagement. *Herpich* v. *Wallace*, 430 F.2d 792 (5th Cir. 1970); *Kane* v. *Central American Mining & Oil, Inc.*, 235 F. Supp. 559, 564 (S.D.N.Y. 1964); *New Park Mining Co.* v. *Cranmer*, 225 F. Supp. 261, 266 (S.D.N.Y. 1963).

Thus, the misappropriation of the proceeds from the sale of Manhattan's bonds was itself a fraud in connection with a securities transaction. Even if deemed to be an act of corporate mismanagement, the misappropriation is nevertheless actionable under 10b-5 as being an act committed as part of an overall fraudulent scheme.

The resolution of the issues raised herein defines the scope of section 10(b) and Rule 10b-5 for an entire class of actions. By affirming the dismissal of the complaint, the Court of Appeals has ruled erroneously on important questions of federal securities law. They have not been but should be decided by the Supreme Court.

II.

The decision appealed from conflicts with the decision of the Court of Appeals for the Fifth Circuit in *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195 (1960).

Petitioner is in precisely the same position as was the plaintiff in *Hooper* v. *Mountain States Securities Corp.*, 282 F. 2d 195 (5th Cir., 1960) cert. denied, 365 U.S. 814, 81 S. Ct. 695 (1961). There, a trustee in bankruptcy was recognized as a proper party to maintain an action on behalf of the corporation which had been defrauded A transfer agent was fraudulently induced to issue corporate stock by misrepresentations that a sale had occurred and was approved by the board of directors. Upon the issuance of $700,000 worth of securities by the transfer agent, the corporation was given worthless properties. No sale or approval had taken place. The Court constructed a sale to bring the case within Rule 10b-5. Although there were no misrepresentations as to the terms of the "sale", the Fifth Circuit held that the misrepresentations made to the transfer agent inducing the "sale" constituted a violation of Rule 10b-5 where the corporation received inadequate consideration. In short, all that must be established to support federal jurisdiction is injury to the corporation as a result of a fraudulent securities transaction. See, *Hoover* v. *Allen*, 241 F. Supp. 213 (S.D.N.Y. 1965); *Simon* v *New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966). Manhattan was injured by the sale of its securities because it received no consideration at all. By affirming the dismissal of the complaint, the Court below is therefore squarely in conflict with the decision of the Fifth Circuit in *Hooper, supra*. The writ of certiorari should be granted in order to resolve the conflict

between the decision appealed from and the decision of the Fifth Circuit in *Hooper, supra.*

III.

The purchaser-seller restriction enunciated in *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952) cert. denied, 343 U.S. 956 (1952) should be abolished.

Before reaching the question of whether Petitioner alleged a violation of Rule 10b-5 in connection with the purchase and sale of the Manhattan stock, the Court of Appeals found that since Manhattan was neither a purchaser or seller of the stock, it lacked standing to sue. The Court relied on *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir. 1952) cert. denied, 343 U.S. 956 (1952) and its reaffirmation in *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968).

The courts have recognized the artificiality of the limitation imposed by the purchaser-seller rule. See, *Hooper, supra; Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967) cert. denied, 389 U.S. 970, 89 S. Ct. 463 (1967); *Stockwell* v. *Reynolds*, 252 F. Supp. 215 (S.D.N.Y. 1965).

Similarly the SEC has consistently argued in recent years as amicus that there is not and ought not to be a mechanical purchaser-seller test for determining standing to sue under Rule 10b-5. *Vine* v. *Beneficial Finance Co., supra; Pacific Insurance Co.* v. *Blot*, 267 F. Supp. 956 (S.D.N.Y. 1967).

Where a private right of recovery is court-created it is likewise within the proper powers of the court to determine the scope of that right. The court in *Birnbaum* relied heavily on the statement of the SEC that Rule 10b-5 closed

a loophole with regard to fraudulent purchases of securities in holding the right of action to be limited to defrauded purchasers or sellers, rather than on the legislative history of the act. The SEC originally promulgated the rule under its duty to protect the public at large and investors in securities. It would seem both judicially proper and appropriate for the courts to rely as heavily today on the position of the SEC in interpreting its own rule as they did in 1952.

Furthermore, it should be noted that Rule 10b-5 was promulgated in 1942, fully four years before a private action for fraud was recognized by the courts. The SEC was concerned at the time with those against whom actions could be brought, not those on whose behalf private actions could be brought, since no private right of action existed at the time. Thus, the SEC intended the scope of the fraud provisions to cover both purchasers and sellers, when such actions were in the public interest or for the protection of investors. The law required a consummated purchase and sale of securities before the SEC could bring an action against a defrauding party.

The Court of Appeals, however, felt it was bound by its decision in *Greenstein* v. *Paul,* 400 F. 2d 580 (2d Cir. 1968). The Court there held that it was necessary for a plaintiff to have been either a purchaser or seller of securities to sustain federal jurisdiction in an action for damages. Unlike *Greenstein, supra,* Petitioner here is not seeking a speculative recovery. Petitioner's damages were fixed by its actual losses of $5,500,000, and is thus entitled to sue in the federal courts for damages resulting from the violation of the securities laws. To hold otherwise when not demanded by law, logic, or sound principles of statutory interpretation can only serve to ossify a statutory scheme

designed to be flexible and to create greater incentive for clever scheming.

Although section 10(b) and Rule 10b-5 may well be the most litigated provisions in the federal securities laws, *SEC* v. *National Securities,* 393 U.S. 453, 465, 89 S. Ct. 564, 571 (1969), this Court has never ruled on the Birnbaum doctrine as it applies to standing. *Id.* n. 9 at 467, 89 S. Ct. at 572. Since the case at bar clearly raises the standing issue, the Court should resolve it by granting the writ of certiorari. *Id.* at 472, 89 S. Ct. 574 (dissenting opinion of Justice Harlan).

IV.

The Court of Appeals, in holding that Petitioner has not alleged a federal cause of action in connection with the transactions in certificates of deposit, has ruled erroneously on an important question of securities law that has not been but should be decided by the Supreme Court.

Subsequent to January 24, 1962, Manhattan was the victim of several separate and distinct proscribed schemes or devices over the following fifteen month period before the facts came to light and Manhattan was placed in liquidation. The schemes or devices are described in The Facts at pp. 7 through 12, *supra.*

Those issues raised in connection with the purchase and sale of Manhattan's bonds are also raised in connection with the purchase and sale of CD's subsequent to January 24, 1962. The Court of Appeals held that Petitioner failed to state a violation of Rule 10b-5 with regard to the latter set of transactions on substantially the same grounds given for denying jurisdiction regarding the events of January

24, 1962: that regardless of any fraud practiced prior to, during, or after the transactions, as long as the CD's were bought and sold for their full face amount, there was no fraud in connection with their purchase and sale within the meaning of Rule 10b-5.

Petitioner expressly incorporates herein the arguments set forth in I, *supra* establishing that the Court of Appeals has ruled erroneously on these issues and that the Supreme Court should issue a writ of certiorari to review the decision.

Furthermore, Manhattan was defrauded in connection with the sale of the $500,000 First National Bank of Boston CD. As a result of the misrepresentations to Sweeny, Manhattan's agent, the proceeds from the sale of the CD were diverted to pay off the debt of New England Note. Sweeny, as President of Manhattan, had authorized its sale only to effect payment for a new certificate. Petitioner is therefore entitled to recover on behalf of Manhattan and its creditors as a defrauded seller of securities within the meaning of section 10(b) and Rule 10b-5.

Petitioner is further entitled to recover as the defrauded purchaser of the Irving Trust CD's under section 17(a). The monies paid by Manhattan to effect payment on the CD's issued by Irving Trust were diverted and paid into the account of Garvin pursuant to the scheme, and the CD's were delivered to Marine Midland where they were held as collateral for a loan to Garvin and Garvin, Bantel.

There is only one sum of money in the amount of $5,500,000 involved in all these schemes and separate recovery for each of the separate and distinct fraudulent schemes is not demanded in excess of that amount. Nonetheless, liability would attach at any one of a number of junctures along the path that led to the liquidation of Manhattan.

At each Manhattan had an asset or a potential asset which was rendered valueless to, or the proceeds of which were diverted away from Manhattan. Indeed these fraudulent transactions, although distinct violations, can be viewed as being part of the original purchase and sale transactions of January 24, 1962. They were the direct result of the fact that Manhattan never received any consideration for its bonds sold that day.

CONCLUSION

The allegations of the complaint as amplified by the record before the Court discloses that the board of directors of Manhattan was fraudulently induced to authorize the sale of securities. The deception of the board was part of an overall scheme to loot the assets of Manhattan by selling its securities. As part of that scheme and as a separate fraudulent act in connection with the sale of securities, the proceeds from such sale were misappropriated so that Manhattan sold a valuable asset and received nothing in return.

The Court below, although recognizing the existence of a fraud, erred in not finding it to be a federally cognizable fraud under section 10(b) and Rule 10b-5. The questions raised in this Petition are of vital importance in the field of securities law and for all of the reasons set forth herein, certiorari should be granted.

Respectfully submitted,

ARNOLD BAUMAN
Attorney for Petitioner
45 Rockefeller Plaza
New York, N. Y. 10020
Tel. 246-8380

Of Counsel:
PHILIP M. KAZIN

APPENDIX

APPENDIX A

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

No. 631—September Term, 1969.

(Argued March 26, 1970 Decided July 22, 1970.)

Docket No. 33869

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of MANHATTAN CASUALTY COMPANY,

Plaintiff-Appellant,

—v.—

BANKERS LIFE AND CASUALTY COMPANY, IRVING TRUST COMPANY, BELGIAN AMERICAN BANKING CORPORATION, BELGIAN AMERICAN BANK & TRUST COMPANY, GARVIN, BANTEL & COMPANY, GEORGE K. GARVIN,

Defendants-Appellees.

BEFORE:

LUMBARD, *Chief Judge,*

HAYS, *Circuit Judge,* and BLUMENFELD, *District Judge.**

Appeals from judgments in favor of defendants entered in the United States District Court for the Southern District of New York, Herlands, *J.*, and Ryan, *J.*, dismissing action brought under the federal Securities Acts, on the

---

* Of the District of Connecticut, sitting by designation.

ground that the complaint failed to state a federal cause of action.

Affirmed.

BLUMENFELD, *District Judge*:

Appellant Superintendent of Insurance of the State of New York, as Liquidator of Manhattan Casualty Company (Manhattan), commenced this action in 1963 alleging violations by ten defendants of § 17(a) of the Securities Act of 1933. On September 10, 1968, defendants Bankers Life and Casualty Company (Bankers Life), Belgian American Bank & Trust Company (Belgian Trust), and Belgian American Banking Corporation (Belgian Banking) moved to dismiss the action before the late Judge Herlands. On October 1, 1968, defendants Irving Trust Company (Irving), Garvin, Bantel & Company (Garvin, Bantel), and George K. Garvin made similar motions before Judge Ryan. On June 4, 1969, Judge Herlands entered judgment dismissing the action as to Bankers Life, Belgian Trust, and Belgian Banking. His thorough and considered decision granting the motions of these defendants is set out at 300 F. Supp. 1083 (S.D.N.Y. 1969). Shortly thereafter, on June 17, 1969, Judge Ryan, concurring in the reasoning of Judge Herlands' opinion, entered judgment dismissing the action as to Irving, Garvin, Bantel, and George K. Garvin. It is from these judgments that the Superintendent appeals. We affirm.

I. *Facts*

Manhattan was a casualty insurance company wholly owned by defendant Bankers Life and operated by it as a subsidiary. In January 1962 two individuals, defendants

Appendix A

Standish T. Bourne and James F. Begole, both now deceased, and not involved in this appeal, agreed to purchase all the stock of Manhattan. On January 19, 1962, a contract was executed between Begole as purchaser and Bankers Life as seller, providing for the sale of the Manhattan stock for $5,000,000 on January 24, 1962. On that day, Begole, John F. Sweeny[1] and C. Joseph Gunter, an officer of Irving, went to Manhattan's office for the closing. Pursuant to plans made in advance of the closing, Gunter tendered an Irving check for $5,000,000 to an officer of Bankers Life and, in exchange, all of the shares of Manhattan stock were given to Begole.

This transaction between Bankers Life and Begole still remains unchallenged because neither the former, as seller, nor the latter, as buyer, has brought any action seeking damages or any relief, one against the other. In this lawsuit our attention has been shifted away from that conventional purchase and sale of the Manhattan stock to the legerdemain employed by the buyer to obtain the $5,000,000 with which to pay for the stock.[2]

---

[1] At oral argument in the district court, it was learned that Manhattan ousted Sweeny from the presidency of Manhattan at about the time that Bankers Life decided to sell the Manhattan stock, and that subsequent to the ouster Sweeny established contact between Begole and Bourne and Bankers Life. Judge Herlands concluded:

> "Probably at that time, Sweeny also arranged with Begole and Bourne that he should be reinstated as president of Manhattan when, and if, Begole and Bourne acquired control of Manhattan." 300 F. Supp. at 1087 and n. 4.

[2] The details of financing the purchase of Manhattan stock were apparently the responsibility of Bourne. He engaged the services of defendant George K. Garvin and the latter's firm of money brokers (Garvin, Bantel), who had arranged in advance for the above transaction as well as those to follow.

Appendix A

Following the closing, but on the same day, United States Government securities (Treasury bonds) from Manhattan's portfolio were sold [3] and the proceeds, amounting to $4,854,552.67, plus enough cash to bring the total to $5,000,000, were credited to an account in the name of Manhattan at Irving, and the $5,000,000 Irving check was then charged against this account. As a result of this first series of transactions, Bankers Life had received $5,000,000 in exchange for the Manhattan stock, Begole and Bourne owned the stock, and Manhattan's assets, having been used to purchase the Manhattan stock, had consequently been reduced by $5,000,000.

---

[3] The complaint is silent as to the source of authority for this sale of securities from Manhattan's portfolio. Noting that fact, Judge Herlands stated:

> "Conceivably it was [Sweeny, apparently installed as president of Manhattan after the stock changed hands] who directed the Chemical Bank to deliver Manhattan's portfolio of . . . securities to Irving Trust, authorized the sale of these securities, and then transferred Manhattan cash to Irving Trust in order to cover completely the $5,000,000 Irving Trust check payable to Bankers Life." 300 F. Supp. at 1089.

He also noted the possibility that a board of directors might have been named, which in turn met and appointed Sweeny as president and granted him authority to effect the transactions on Manhattan's behalf. *Id.* at 1089 n. 6.

Appellant vigorously contends that this represents a serious misunderstanding of fact vital to his theory of recovery. His contention is that the sale of Treasury bonds was authorized by resolution of the board of directors on the basis of a representation that the sale of bonds and purchase of a certificate of deposit was merely a change in the company's investment portfolio. Although every minute detail of the pretenses used by Begole and his associates to mask their fraudulent activity may not have been adduced from the complaint or from the other parts of the record as augmented after some six years of discovery, we are satisfied that the able district judges overlooked nothing that would affect the character of the claim.

Appendix A

In order to conceal the depletion of Manhattan's assets,[1] the individuals now in control of Manhattan had a neatly prepared ruse ready at hand. At Garvin's request, Irving issued a second check for $5,000,000 payable to Belgian Trust. Sweeny, president of Manhattan, used this check to buy a $5,000,000 six-month's certificate of deposit from Belgian Trust payable to Manhattan. That certificate was then endorsed by Sweeny as president of Manhattan to New England Note Corporation (New England) and delivered to Bourne, president of New England. Bourne then endorsed and delivered it to Belgian Banking as collateral for a six-month's $5,000,000 loan from Belgian Banking to New England. The proceeds of this loan were then delivered to Irving to cover its $5,000,000 check drawn to the order of Belgian Trust.

To recapitulate, there were two sets of telescoped transactions—all completed on the same day:

A. All of Manhattan's shares were purchased from Bankers Life for $5,000,000, borrowed from Irving. After thus gaining control of Manhattan, the purchaser sold government bonds out of Manhattan's portfolio and used the proceeds to pay off the loan from Irving.

B. To conceal the above depletion of Manhattan's assets, the new owners of Manhattan and those they put in control arranged for a second loan from Irving for $5,000,000. With this they bought a $5,000,000 certificate of deposit from Belgian Trust in the name of Manhattan, and assigned that to New England (Bourne). New England en-

[1] The financial ability of corporations engaged in the business of liability insurance to meet claims against its policyholders is subject to regulation under the laws of New York. Their books are open to regular inspection by experts in that business employed by the insurance department of the State of New York.

dorsed it to Belgian Banking as security for a $5,000,000 loan to New England. The proceeds were then used to repay Irving's second loan. However, Manhattan's books reflected only the sale of its government bonds and the purchase of the certificate of deposit. Manhattan's records did not show (1) that the proceeds of the sale of these bonds were used by Begole to pay for his purchase of Manhattan's shares or (2) that the certificate of deposit had been assigned to New England and by it pledged to Belgian Banking.

The loans and certificates outlined in *B.* were twice renewed. The first renewal was in July 1962. In January 1963, when Belgian Banking refused to renew its loan to New England a similar round robin set of transactions was effected by substituting Marine Midland Trust Company to perform Belgian Banking's role. In April 1963 the New York Insurance Department discovered the inadequacy in Manhattan's assets and placed the company in liquidation.

II. *Appellant's Claims*

The complaint alleges that the foregoing related transactions constituted one or more violations of § 17(a) of the 1933 Act, 15 U.S.C. § 77q(a).[5] The district court properly considered as well the applicability to the pleaded facts

---

[5] Section 17(a) provides:

"It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly—

"(1) to employ any device, scheme, or artifice to defraud, or

"(2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the

of § 10(b) of the 1934 Act, 15 U.S.C. § 78j(b)[6] and of S.E.C. Rule 10b-5[7] promulgated thereunder. See *Hoover* v. *Allen*, 241 F. Supp. 213, 226 n. 7 (S.D.N.Y. 1965). On appeal, appellant claims the pleaded facts, as well as those otherwise contained in the record, establish his right to recover under one or both of these sections for fraud perpetrated (1) in connection with the purchase and sale of the Manhattan stock, (2) in connection with the sale of Treasury bonds from Manhattan's portfolio, and (3) in connection

---

light of the circumstances under which they were made, not misleading, or

"(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

[6] Section 10(b) provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securites exchange—

* * * * * *

"(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors."

[7] Rule 10b-5 provides:

"It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

"(1) to employ any device, scheme, or artifice to defraud,

"(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

"(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

"in connection with the purchase or sale of any security."

with transactions involving certificates of deposit and occurring after January 24, 1962. We disagree and affirm the decision of the district court.

III. *Sale of Manhattan Stock*

Section 17(a) of the 1933 Act provides a cause of action only for a defrauded purchaser. *Schoenbaum* v. *Firstbrook*, 268 F. Supp. 385, 396 (S.D.N.Y. 1967), *aff'd*, 405 F.2d 200 (2d Cir.), *rev'd in part on other grounds*, 405 F.2d 215 (2d Cir. 1968) (*en banc*), *cert. denied* sub nom. *Manley* v. *Schoenbaum*, 395 U.S. 906 (1969). Section 10(b) of the 1934 Act and Rule 10b-5 extend a similar right to a defrauded seller as well as to a purchaser of securities. *Greenstein* v. *Paul*, 400 F.2d 580, 581 (2d Cir. 1968); *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); see *Christophides* v. *Porco*, 289 F. Supp. 403, 406 (S.D.N.Y. 1968).[8] Bankers Life was the seller of the Manhattan stock; Begole the purchaser. There is no theory under which Manhattan, in whose shoes this appellant stands, may be regarded as either the purchaser or the seller of Bankers Life's Manhattan stock. Consequently the appellant does not fall within the classes of those for whom a cause of action is created either by § 17(a) of the 1933 Act or § 10(b) of the

[8] Although there has been some judicial expansion of the category of persons who may be considered "purchasers," cf. *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967), or "sellers" see *Vine* v. *Beneficial Fin. Co.*, 374 F.2d 627 (2d Cir.), *cert. denied*, 389 U.S. 970 (1967); *Hooper* v. *Mountain States Sec. Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied*, 365 U.S. 814 (1961), nothing in the cited cases undermines the now well-settled purchaser-seller rule of *Birnbaum*, especially in view of its recent reaffirmation in *Greenstein*. But see, *Weitzen* v. *Kearns*, 271 F. Supp. 616, 622 (S.D.N.Y. 1967); *Entel* v. *Allen*, 270 F. Supp. 60, 69 (S.D.N.Y. 1967).

1934 Act for damages incurred as a result of that transaction.

IV. *Sale of Manhattan's Treasury Bonds*

Another thrust of this appeal is that the district court erred in holding that no federal cause of action was stated with respect to the purchase or sale of Treasury bonds from Manhattan's portfolio. Appellant's claim that Manhattan is entitled to federal relief as the defrauded seller of those bonds was presented to the district court only as "amendatory allegations presented in open court and not formally set forth in the complaint." 300 F. Supp. at 1098. Moreover, the alleged facts presented in support of the claim on appeal do not appear anywhere in the complaint. *See* note 3, *supra*. Assuming that they are properly before us, and also that they are true, *Kossick* v. *United Fruit Co.*, 365 U.S. 731, 732 (1961), we hold that appellant has not made out a claim cognizable under the federal Securities Acts.

Briefly stated, appellant's claim is that a majority of the board of directors of Manhattan was deceived by misrepresentations of other members of the board and some of the defendants that the sale of the bonds was intended only to effectuate a substitution of those assets for a certificate of deposit equal in value; that in fact the certificate of deposit so substituted was collateralized to its full face value in favor of an unrelated corporate entity; and that on the basis of the fraudulent representations, the board was deceitfully induced to authorize the sale of the bonds in exchange for a certificate without value to the corporation.

What distinguishes the fraud perpetrated on Manhattan in this case from one cognizable under Rule 10b-5 is that

its sole object was to obtain possession of Manhattan's government bonds for the personal use of the perpetrators. No doubt the deception was successful, for had the board known that Sweeny and his associates intended to misappropriate the proceeds for their own use it undoubtedly would not have authorized their sale. But that deception did not infect the subsequent sales transaction. With respect to the terms of the sale itself neither the purchaser nor the seller of the bonds was deceived or defrauded. Cf. *Ruckle* v. *Roto Am. Corp.*, 339 F.2d 24 (2d Cir. 1964); *Globus, Inc.* v. *Jaroff*, 266 F. Supp. 524 (S.D.N.Y. 1967); *Simon* v. *New Haven Board & Carton Co.*, 250 F. Supp. 297 (D. Conn. 1966). Indeed, it is no part of the liquidator's claim that the full and fair market price was not paid for those bonds by their purchaser. The fraud which harmed the plaintiff consisted of the failure of Sweeny and his associates to account for the proceeds. There is a structural difference between the sale of the corporation's bonds at a concededly fair price and the subsequent fraudulent misappropriation of the proceeds received.

Rule 10b-5 was not intended to provide a remedy for schemes amounting to no more than "fraudulent mismanagement of corporate affairs." *Birnbaum* v. *Newport Steel Corp.*, *supra*, 193 F.2d at 464. The scope of the rule must be assessed in light of the purposes of the legislation from which it derives, which we recently found to be "to promote free and open public securities markets and to protect the investing public from suffering inequities in trading . . ." *SEC* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833, 858 (2d Cir. 1968) (*en banc*), *cert. denied* sub nom. *Coates* v. *SEC*, 394 U.S. 976 (1969). In that case, we construed the "in connection with" requirement of Rule 10b-5 as follows:

> "Therefore it seems clear from the legislative purpose Congress expressed in the Act, and the legislative history of Section 10(b) that Congress when it used the phrase 'in connection with the purchase or sale of any security' intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon, and, in connection therewith, so relying, cause them to purchase or sell a corporation's securities." *Id.* at 860.

See *Heit* v. *Weitzen*, 402 F.2d 909, 913 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

The fraud alleged in this case in no way affected either the securities markets or the investing public. No stockholders were defrauded, no investor injured. The purity of the security transaction and the purity of the trading process were unsullied. There was no danger that the securities sold would be overvalued on reaching the public markets. Cf. *Ruckle* v. *Roto Am. Corp., supra,* 339 F.2d at 28.

Despite the power of the Commission to promulgate rules "appropriate in the public interest or for the protection of investors," §78j(b), the scope of the rule in fact promulgated is expressly limited to protection against fraud or deceit "in connection with the purchase or sale of any security." Rule 10b-5. Although in the broadest sense the public interest is involved when a corporation which is subject to regulation by the state Superintendent of Insurance is defrauded, the public interest cognizable by §10(b) is limited to preserving the integrity of the securities markets. The civil liberties provisions of the federal Securities Acts, beginning in 15 U.S.C. §77(*l*) were "part of a broad integrated program designed to obtain

honest dealings in securities," *Wilko* v. *Swan*, 127 F. Supp. 55, 58 (S.D.N.Y. 1955), not one to create an unlimited federal right of action for damages for all who have been defrauded in any area of economic activity. The condition imposed by Rule 10b-5 that the fraud be in connection with the purchase or sale of a security is wholly consistent with that program. Thus, we do not decide that the creditors of Manhattan do not have any remedy under general state tort law for the fraud practiced on their debtor, but only that the federal Securities Acts have not provided a federal forum for its enforcement.

V. *Transactions Involving Certificates of Deposit*

Appellant also contends that Manhattan was defrauded in connection with both purchases and sales of various six-month certificates of deposit exchanged after January 24, 1962. These transactions, which were integral parts of the scheme [9] to conceal the prior depletion of Manhattan's assets, are sufficiently described in the opinion below and need not be fully restated here. The conclusion we have reached that the sale of Manhattan's Treasury bonds did not present a federal cause of action applies equally to these transactions. The certificates of deposit or their proceeds may have been fraudulently misapplied, but there was no fraud in connection with their purchase or sale. In each instance they were bought and sold for their full face amount.

---

[9] Although the plaintiff contends that it is clear that liability would attach at any one of a number of junctures along the path that led to the liquidation of Manhattan, it expressly disclaims the right to separate recoveries for each of these "separate and distinct fraudulent schemes."

Since we have considered those facts appellant would include in an amendment of his complaint in reaching our conclusion that a claim for relief under the federal Securities Acts is not alleged, we also affirm the district court's denial of the motion to amend.

Affirmed.

HAYS, *Circuit Judge* (dissenting):

Plaintiff has succeeded to all the rights of Manhattan and is the proper person to assert those rights. See *Hooper* v. *Mountain States Securities Corp.*, 282 F.2d 195, 206-07 (5th Cir. 1960), cert. denied, 365 U.S. 814 (1961), where plaintiff was the defrauded corporation's trustee in bankruptcy.

Manhattan was the victim of a "scheme . . . to defraud" (Rule 10b-5). Judge Blumenfeld has adequately described that scheme. Since the vital center of the scheme, the vehicle for the perpetration of the fraud, was the sale of Manhattan's stock, it seems to me to be completely unrealistic to say that the fraud was not committed "in connection with the purchase or sale of any security."

This court has repeatedly indicated its intention to give a broad and liberal interpretation to Rule 10b-5 in order to assure that that provision is used to accomplish the beneficent purposes for which the statutes governing sales of securities were enacted. See *Ruckle* v. *Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964); *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir.), cert. denied, 389 U.S. 970 (1967); *A. T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967); *S.E.C.* v. *Texas Gulf Sulphur Co.*, 401 F.2d 833 (2d Cir. 1968) (*en banc*), cert. denied sub nom. *Coates* v. *S.E.C.*, 394 U.S. 976 (1969); *Schoenbaum* v. *Firstbrook*,

405 F.2d 215 (2d Cir. 1968) (*en banc*), cert. denied sub nom. *Manley* v. *Schoenbaum*, 395 U.S. 906 (1969); *S.E.C.* v. *Great American Industries, Inc.*, 407 F.2d 453 (2d Cir. 1968) (*en banc*), cert. denied, 395 U.S. 920 (1969). In our most recent expression on the subject, we said that "[t]he purchase-sale requirement must be interpreted so that the broad design [of the statutes] . . . is not frustrated by the use of novel or atypical methods" and we quoted from *S.E.C.* v. *Texas Gulf Sulphur, supra*, the following language *inter alia*: "the courts, as they should, have broadly construed the statutory phrase 'in connection with the purchase or sale of any security.'" *Crane Co.* v. *Westinghouse Air Brake Co.*, 419 F.2d 787, 798 & n. 14 (1969).

In my opinion, the purposes of the statutes would be best accomplished here by recognizing plaintiff's standing to enforce the duties created by those statutes.

APPENDIX B

33869

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of Manhattan Casualty Co.,

Plaintiff-Appellant,

—v.—

BANKERS LIFE AND CASUALTY COMPANY, *et al.*,

Defendants,

BANKERS LIFE AND CASUALTY CO., *et al.*,

Defendants-Appellees.

A petition for a rehearing having been filed herein by counsel for the appellant,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is DENIED.

J. EDWARD LUMBARD

M. JOSEPH BLUMENFELD
per J.E.L.

I dissent and vote for rehearing

/s/ PAUL R. HAYS

September 30, 1970

APPENDIX C

33869

UNITED STATES COURT OF APPEALS

SECOND CIRCUIT

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK,
as Liquidator of Manhattan Casualty Co.,

Plaintiff-Appellant,

—v.—

BANKERS LIFE AND CASUALTY COMPANY, *et al.*,

Defendants,

BANKERS LIFE AND CASUALTY CO., *et al.*,

Defendants-Appellees.

A petition for a rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellant and no active circuit judge having requested that a vote be taken on said suggestion,

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

J. EDWARD LUMBARD
Chief Judge

September 30, 1970

APPENDIX D

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

63 Civ. 2490—June 3, 1969

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of Manhattan Casualty Co.,

Plaintiff,

—v.—

BANKERS LIFE AND CASUALTY COMPANY, Irving Trust Company, Belgian American Banking Corporation, Belgian American Bank & Trust Company, Garvin, Bantel & Company, New England Note Corporation, George K. Garvin, John F. Sweeny, the Estate of Standish T. Bourne, by Standish T. Bourne, Jr., as Executor, the Estate of James F. Begole, by Patricia C. R. Begole, Executrix,

Defendants.

HERLANDS, *District Judge*:

The issue for decision is another illustration of the recurring problem whether plaintiff's claim belongs in the state courts or whether plaintiff has stated a cause of action under the federal securities laws—the Securities Act of 1933 (1933 Act), 15 U.S.C. §§77 *et seq.* (1964) and the Securities Exchange Act of 1934 (1934 Act), 15 U.S.C. §§78 *et seq.* (1964), and the pertinent rules and regulations of the Securities and Exchange Commission. This question is posed by motions made by three of the defendants to dismiss the complaint.

Appendix D

The movants are defendants Bankers Life and Casualty Company ("Bankers Life"), Belgian American Banking Corporation ("Belgian American Banking"), and Belgian American Bank and Trust Company ("Belgian American Trust").

The grounds of the motions are (1) that there is lack of jurisdiction over the subject matter; (2) that the complaint fails to state a claim upon which relief can be granted; and (3) that plaintiff lacks the requisite standing to recover damages for alleged violations of the 1933 and 1934 Acts.

Defendants maintain that plaintiff may not recover because (i) it[1] is neither a defrauded purchaser nor a defrauded seller of securities within the meaning of the 1933 and 1934 Acts, and (ii) these federal statutes have never been and should not be interpreted so as to make them applicable to remedy the injury allegedly resulting from the facts asserted in the complaint. A comprehensive restatement of the facts alleged in the complaint is requisite for a comprehension of the following discussion of the critical legal issues.[2]

---

[1] The Superintendent of Insurance of the State of New York is the nominal plaintiff. Since he, as Liquidator, has been vested with all rights of the Manhattan Casualty Company (hereinafter "Manhattan"), the rights he seeks to assert are precisely those possessed by Manhattan at the time of his appointment as Liquidator. Consequently, the questions of standing to initiate suit and of injury will be determined as if Manhattan itself had brought suit.

[2] These motions were made pursuant to an order entered by District Judge Sylvester J. Ryan on June 19, 1968 denying, without prejudice, a motion for summary judgment under Fed. R. Civ. P. 56(b), (c) because subject matter jurisdiction was doubtful. In light of that motion and its disposition, this Court will not treat the instant motions as motions for summary judgment by looking outside the face of the pleadings. The Court will rule on the questions of jurisdiction and the sufficiency of the complaint solely on the basis of its allegations.

The complaint, however, does not contain "a short and plain statement" (Fed. R. Civ. P. 8(a)) of the claim; its averments are

Appendix D

EVENTS PRIOR TO JANUARY 24, 1962

Manhattan Casualty Company ("Manhattan") was a New York corporation engaged in the insurance business. At the beginning of the period under consideration, Bankers Life was the owner of all of the outstanding shares of Manhattan stock. The management of Manhattan apparently was distinct from that of Bankers Life.

During the fall of 1961, Bankers Life decided to discontinue its ownership of Manhattan. Sometime in November, 1961,[3] Bankers Life, through James W. Bourland, a vice-president of Bankers Life, commenced negotiations for the sale of all the Manhattan stock. The prospective purchasers were two individuals, defendants Standish T. Bourne and James F. Begole. (¶19).

At about the time that Bankers Life decided to sell its Manhattan stock, it ousted the defendant John F. Sweeny from the presidency of Manhattan.[4] Sweeny, however, established contact betwen Begole and Bourne and Bankers

---

not "simple, concise and direct" (Fed. R. Civ. P. 8(e)); and the intricacies of the pleaded transactions cannot immediately be interrelated.

As a consequence, the Court has been compelled to undertake the task of describing the sequence of events as coherently as the complaint permits. The Court has noted, when necessary, the gaps in the narrative which were filled through other sources (these facts not playing a part in the disposition of the motions) and those gaps which remain void.

[3] Paragraph 18 of the complaint alleges that the acts in furtherance of and connection with the scheme to defraud were commenced in November, 1962. However, it is obvious from the succeeding paragraphs that this date is a typographical error, and that the correct date is November, 1961.

[4] This information was conveyed to the Court at oral argument (Transcript, September 10, 1968 at 23-25). Sweeny's former relationship with Manhattan, his discharge by Bankers Life, and his subsequent connection with Bourne and Begole, are important for an understanding of the alleged fraud.

Life. Probably at that time, Sweeny also arranged with Begole and Bourne that he should be reinstated as president of Manhattan when, and if, Begole and Bourne acquired control of Manhattan.

The negotiations drew to a successful conclusion. On January 19, 1962, a contract for the purchase and sale of all the Manhattan shares was entered into by Bankers Life (still through Bourland, as its vice-president) and Begole, individually. Begole, alone and in his own name, was to purchase the Manhattan shares. He agreed to deliver to Bankers Life at the closing on January 24, 1962 a bank check or certified check in the amount of $5,000,000. (¶20).

The complaint does not charge that any misrepresentations, deceit or non-disclosures had been made or practiced upon any party in connection with this contract of purchase and sale. The complaint is devoid of allegations respecting the net worth of Manhattan or its general financial position; thus, there is nothing upon which to base any finding as to the equity or unfairness of the contract.

Financing

Sometime after January 19, 1962 but before the closing date (January 24, 1962), Bourne had stated to Begole that he, Bourne, would arrange for the financing of the stock acquisition. (¶21). Bourne made contact with defendant George K. Garvin (a partner in the note brokerage firm Garvin, Bantel & Company, also a party defendant) and asked Garvin to have a bank issue certificates of deposit in the face amount of $5,000,000 and then to have a bank make a loan, using the certificates as collateral. (¶22). Other than the conclusory statement that the purpose of these two transactions was to conceal the scheme to defraud, there is nothing in the complaint's factual allegations that

would explain the significance of these two transactions which, taken together, appear to be self-cancelling.

Acting upon Bourne's request, Garvin, prior to January 24, 1962, arranged with Belgian American Trust to issue a certificate of deposit in the face amount of $5,000,000, in the name of Manhattan. (¶23). The complaint is silent, however, as to whether Belgian American Trust was informed of the method of payment for this certificate of deposit. Presumably, it was so informed. Garvin also arranged with Belgian American Baking to loan to defendant New England Note Corporation—a company controlled by Bourne—$5,000,000 upon the collateral of the certificate of deposit that would be issued in the name of Manhattan. (¶23).

Also in preparation for the closing of January 24, 1962, Garvin met with C. Joseph Gunther, an officer of defendant Irving Trust Company. Gunther agreed to bring to Garvin's office on January 24, 1962 a check in the amount of $5,000,000 payable to Bankers Life. This check was to be paid for by the delivery of various securities from Chemical Bank New York Trust Company to Irving Trust Company. (¶24).

TRANSACTIONS OF JANUARY 24, 1962

The Closing, the Payment for the Manhattan Shares, and the Sale of Manhattan's Portfolio

On the morning of January 24, 1962, Bourne, Sweeny, Begole, and Gunther appeared at Garvin's office. Begole then executed two notes,[5] both payable to New England

[5] There are no allegations respecting the obligor, *i.e.*, whether these were personal notes of Begole or were to become obligations of Manhattan. It seems more likely that they were personal obligations of Begole because of the assignment of the shares by Begole to New England Note Corporation, which may have been intended as an assignment for security purposes.

Note Corporation. One was in the amount of $5,000,000, interest payable at 7½ per cent; the other in the amount of $250,000, interest payable at 5 per cent. The complaint is silent as to whether these notes were delivered. Begole also executed in favor of New England Note Corporation an assignment of the Manhattan stock that he would receive. (¶25). The economic purpose underlying these transactions is neither explained nor readily discernible.

Sweeny, Begole, Garvin, and Gunther then went to Manhattan's office for the closing of the sale of Manhattan stock. Gunther handed the $5,000,000 Irving Trust Company check to Leo Lehane, an executive vice-president of Bankers Life, and received in return an unsealed envelope. (¶26). The complaint contains no other allegations pertaining to the actual closing. It would be sheer speculation to assume that the envelope did or did not contain the shares of Manhattan stock.

Nevertheless, Begole and Bourne presumably did obtain possession of the shares of Manhattan stock at some point because (as will be detailed later) these shares apparently were physically tendered as security for a loan.

Once the ownership of the shares of Manhattan stock apparently changed hands on January 24, 1962, the following took place: United States Government securities owned by Manhattan, in the face amount of $5,155,000, were delivered through Garvin, Bantel & Company to Irving Trust Company.

During the same day of January 24, 1962, Garvin, Bantel & Company sold these securities for Manhattan's account. Irving Trust Company delivered these securities to the purchaser and received the proceeds of $4,854,552.67, which amount it then credited to an account in Manhattan's name.

Manhattan (by some person not named) then transferred some cash to Irving Trust Company, which amount was also credited to this Manhattan account.

Finally, the $5,000,000 check of Irving Trust Company that Gunther had handed to Leo Lehane of Bankers Life was charged against this same Manhattan account in Irving Trust Company (¶27)—which had been built up by the crediting of the proceeds of the sale of Manhattan's portfolio of United States Government securities plus the additional Manhattan cash.

The net effect of the foregoing series of financial manoeuvres appears to be, up to this point, as follows:

(i) Bankers Life received $5,000,000 in cash for which it had ostensibly delivered all of its Manhattan stock;

(ii) Presumably, Begole (or possibly Bourne—through New England Note Corporation—as a result of Begole's prior assignment of the Manhattan stock Begole would receive) owned all of the stock of Manhattan;

(iii) Manhattan's portfolio of United States Government securities had been sold off;

(iv) Manhattan transferred some cash to Irving Trust, thereby further building up its account;

(v) Irving Trust applied the total credit—created out of the Manhattan portfolio proceeds and the Manhattan cash—to the payment of the $5,000,000 Irving Trust check which Gunther had given Lehane of Bankers Life;

(vi) As a result, Manhattan's net assets were diminished by approximately $5,000,000; and

(vii) Payment of $5,000,000 to Bankers Life for the purchase of its Manhattan stock was effected by using Man-

hattan's own assets to pay for all of its stock, which Begole or Bourne thereby obtained without using a dollar of their own money.

Though the complaint is devoid of factual allegations on the point, apparently Sweeny assumed the office of president of Manhattan immediately after the acquisition of the Manhattan shares.[6] Conceivably it was he who directed the Chemical Bank to deliver Manhattan's portfolio of United States Government securities to Irving Trust, authorized the sale of these securities, and then transferred Manhattan cash to Irving Trust in order to cover completely the $5,000,000 Irving Trust check payable to Bankers Life.

The complaint is explicit, however, in charging that Sweeny, in his capacity as president of Manhattan, effected other transactions on January 24, 1962.

The Certificates of Deposit

Later that day, Gunther, at the request of Garvin, Bantel & Company, brought another Irving Trust check in the amount of $5,000,000, payable to Belgian American Trust, to the offices of Belgian American Trust. Gunther gave the check to Sweeny who delivered it to someone at Belgian American Trust. Belgian American Trust then issued a six-months certificate of deposit in the amount of $5,000,000 in the name of Manhattan, pursuant to Garvin's prior dis-

[6] In light of allegations that Bourne was required by Irving Trust, through Garvin, to execute certain backdated letters (¶32) and that Irving Trust made various entries after January 24, 1962 for the purpose of concealing the transactions of January 24, 1962 (¶31), the absence of any similar allegations respecting Sweeny's grant of authority might indicate that Begole, in fact, did immediately name a board of directors, which met and appointed Sweeny as president, granting him sufficient authority to effect the various transactions on Manhattan's behalf.

cussions with Belgian American Trust. Sweeny received the certificate of deposit and, in his capacity as president of Manhattan, immediately endorsed it to New England Note Corporation. (¶28).

Bourne, as president of New England Note Corporation, accepted the certificate of deposit from Sweeny; and, in turn, Bourne endorsed the certificate to Belgian American Banking.[7]

Belgian American Banking then made a six-months loan of $5,000,000 to New England Note Corporation and took possession of the certificate of deposit as collateral.

Belgian American Banking drew a $5,000,000 check, apparently payable to Irving Trust Company and delivered it to Gunther. (¶28).

To recapitulate for a moment at this point:

(1) Irving Trust Company in effect exchanged its $5,000,000 check payable to Belgian American Trust for a $5,000,000 check drawn by Belgian American Banking, payable to Irving Trust Company.

(2) Belgian American Trust issued a $5,000,000 certificate of deposit which in reality was paid for by the $5,000,000 emanating from Belgian American Banking in the form of the loan in the same amount made by Belgian American Banking to New England Note Corporation and collateralized by the very same $5,000,000 certificate of deposit of Belgian American Trust.

(3) The certificate of deposit issued by Belgian American Trust was issued in the name of Manhattan, though Man-

[7] The exact relationship between Belgian American Banking and Belgian American Trust was never explained in the complaint, nor at oral argument nor in counsel's briefs. It does not appear that, for purposes of these motions, this information is crucial.

hattan did not pay for it and was in fact only an intermediate conduit for this certificate of deposit as it made its way from Belgian American Trust to Belgian American Banking.

At the same time that Belgian American Banking made the $5,000,000 loan to New England Note Corporation, it made another loan of $250,000 to New England Note Corporation and received as security the Manhattan shares assigned by Begole to New England Note Corporation. (¶28). Once again the complaint is not precise and does not allege specifically whether the Manhattan shares were actually delivered to Belgian American Banking.

The proceeds of this $250,000 loan were deposited in Belgian American Trust and the following amounts totalling $225,000 were disbursed: Garvin, Bantel — $25,000; Begole — $50,000; Bourne — $50,000; Belgian American Banking — $100,000. (¶28) It would be suppositious to attempt any explanation for the payment of the above $225,000. The complaint does not allege that this transaction constituted fraud, but only that the various transactions with the Belgian American banks were effected for the purpose of concealing the fact that Manhattan's assets had been reduced by the sale of its securities—a fact which does, indeed, emerge clearly from the above labyrinthine transactions.

Events Subsequent to January 24, 1962

The complaint alleges other events which occurred subsequent to January 24, 1962, such as the making of entries by Irving Trust Company for the purpose of concealing the transactions of January 24, 1962 (¶31); and, for similar purposes, the execution by Bourne of various backdated letters which were given to Garvin on January 29, 1962 (¶32).

Appendix D

On July 24, 1962, the six-months certificate of deposit matured; the loan by Belgian American Banking to New England Note Corporation and the loans by New England Note Corporation to Begole fell due. Belgian American Trust then issued a new six-months certificate of deposit in Manhattan's name in the amount of $5,000,000. This certificate was endorsed by Begole (as chairman of Manhattan) and Sweeny (as treasurer) and posted as collateral for the Belgian American Banking-New England Note Corporation loans which were then extended to January 24, 1963. (¶33). The Manhattan stock at this point appears to be physically in the possession of Belgian American Banking as collateral for the loans. Finally, Begole's loans ($5,000,000 and $250,000) from New England Note Corporation were also extended to January 24, 1963. (¶33). It is alleged that these transactions were entered into for the purpose of furthering the scheme to defraud. (¶33).

While it would appear from the foregoing that Belgian American Banking was in possession of the $5,000,000 certificate of deposit, on August 30, 1962 Sweeny (in his capacity as president of Manhattan) wrote Belgian American Trust that he was forwarding to Belgian American Trust a non-negotiable certificate of deposit in the amount of $5,000,000 which was to be paid at maturity into Manhattan's current account at Belgian American Trust. Sweeny also stated that he was forwarding a non-negotiable certificate of deposit in the amount of $500,000 issued by the First National Bank of Boston, which certificate was to be held by Belgian American Trust in safekeeping. There are no allegations respecting the purchaser of this certificate, the source of funds for its issuance, nor any fraudulent activity in connection with it. Again, the complaint alleges that the purpose of this legerdemain was to conceal the actual reduction in Manhattan's assets and to create

the misleading impression that Manhattan had $5,500,000 more in unencumbered assets than it, in fact, did have. (¶34).

Repayment of Belgian American Banking Loans

Sometime in January, 1963, Belgian American Banking made known that it would not renew or extend its loans to New England Note Corporation, which notes fell due on January 24, 1963. (¶35). Accordingly, beginning on or about January 20, 1963, Bourne and Begole initiated another series of camouflaging transactions.

Firstly, Bourne asked Garvin, Bantel to arrange to replace the certificates of deposit which undoubtedly had been carried as assets upon Manhattan's books and the proceeds of which would be required to repay the Belgian American Banking loans. Garvin, Bantel borrowed $5,500,000 from Marine Midland Bank and Trust Co. and delivered the funds to Irving Trust Company. Irving Trust Company, on January 21, 1963, issued, at Begole's request, certificates of deposit in the amount of $5,500,000, apparently with Manhattan as payee.[8] These certificates were delivered to Garvin, Bantel. (¶36).

Secondly, on January 25, 1963, Belgian American Trust credited Manhattan's account with the proceeds and interest of the two certificates of deposit referred to in Sweeny's letter of August 20, 1962—$5,075,616.44 representing the amount credited with respect to the Belgian American

[8] Paragraph 36 is silent as to the payee of the Irving Trust certificates. However, since paragraph 39 alleges that Irving Trust certified to the State Insurance Department that it was indebted to Manhattan in the amount of $5,500,000 as evidenced by certificates of deposit, and since the alleged scheme of concealing the diminution of assets would not be effective unless the certificates were in Manhattan's name, it is a reasonable assumption that they were so issued.

Appendix D

Trust certificate of $5,000,000 and $515,361.18 representing the proceeds of the First National Bank of Boston certificate of $500,000. (¶37).

At Manhattan's request, Belgian American Trust issued a check in the sum of $5,500,000 to Irving Trust Company and charged Manhattan's account.

Irving Trust Company thereupon drew its own check in favor of Belgian American Banking in the amount of $5,250,000 and charged this amount of $5,250,000 against the credit established by the $5,500,000 check which it had received from Belgian American Trust. The Irving Trust Company check in the amount of $5,250,000 was then applied by Belgian American Banking to the New England Note Corporation loans (of $5,000,000 and $250,000) then due and owing to Belgian American Banking. (¶37).

It is alleged that the exchange of checks between Belgian American Trust and Irving Trust Company and between Irving Trust Company and Belgian American Banking took place at the same time at a meeting held on January 25, 1963 at the office of one (or possibly both) of the Belgian American banks. (¶37).

As a result of these transactions, it now appeared that Manhattan was the payee of a $5,500,000 certificate of deposit (issued by Irving Trust Company) which, however, had been delivered physically to Garvin, Bantel and then undoubtedly used by Garvin, Bantel as security for its loan of $5,500,000 from Marine Midland Bank.[9]

---

[9] There are no allegations, however, regarding the pledge or assignment of this certificate as security nor any allegations regarding an assignment or endorsement by Manhattan of the Irving Trust Company certificate of deposit (of $5,500,000) which presumably would be necessary in order to make this certificate acceptable to Marine Midland Bank as security for Garvin, Bantel's loan.

Appendix D

Manhattan also had approximately $90,000 on deposit in Belgian American Trust representing interest earned by the certificate of deposit and a balance of $250,000 in Irving Trust Company representing the difference between the $5,500,000 check received by Irving Trust Company from Belgian American Trust and the $5,250,000 check issued by Irving Trust Company to Belgian American Banking. There are no allegations respecting interest on the Belgian American Banking-New England Note Corporation loans; and it is likely that Manhattan paid this interest by using the cash balances on deposit in Belgian American Trust and Irving Trust.

Other than these possibilities arising from the interest earned by the certificates of deposit and the interest payable on the loans, the Belgian American banks, as of January 25, 1963, do not figure in any financial transaction.

On April 18, 1963, Belgian American Banking returned to Begole and Sweeny the shares of Manhattan stock which it had received as collateral on the New England Note Corporation loan. (¶38).

Finally, on May 15, 1963, allegedly for the purpose of concealing the diminution of Manhattan's assets, Irving Trust Company certified to the New York State Insurance Department that Manhattan had on deposit at Irving Trust Company $5,500,000, as evidenced by the certificates of deposit (payable to Manhattan) issued by Irving Trust on January 21, 1963. The certification included statements that the certificates of deposit were free of all liens, claims, or incumbrances and were not held as security for any loan. (¶39). These certificates of deposit, as previously noted, had in fact been delivered to Garvin, Bantel.

The net effect of the myriad financial manoeuvres was that an individual (Begole) or a group of individuals

(Begole, Bourne, et al.) obtained control of Manhattan by (1) having Irving Trust Company deliver its $5,000,000 check to Bankers Life (the then sole stockholder of Manhattan), (2) receiving all of Bankers Life's shares of Manhattan, and (3) repaying Irving Trust Company by selling Manhattan's portfolio of United States Government securities and forwarding the proceeds plus some additional cash to Irving Trust Company.

In essence, Manhattan's corporate funds that should have been kept available to meet Manhattan's creditors' and policyholders' claims were thus unlawfully used by Begole for the noncorporate, private purpose of enabling Begole (and those in concert with him) to acquire all of Manhattan's shares.

Since Manhattan, a solvent corporation, was thereby rendered insolvent, the corporation itself was victimized. But, inasmuch as Begole was Manhattan's sole stockholder, the economic injury was to be borne only by Manhattan's creditors and policyholders.

It is impossible to ascertain with any degree of certainty from the face of the complaint who benefitted from the transaction. Bourne, Sweeny, Begole, Garvin or all of them in concert, may have masterminded and gained from the scheme. As previously noted, Bourne, Begole, Garvin, Bantel and Belgian American Banking received various amounts of cash, totalling $225,000, originating out of the $250,000 loan by Belgian American Banking to New England Note Corporation.

Indeed, if Manhattan had a net worth on January 24, 1962 substantially below $5,000,000, Bankers Life may have been the ultimate beneficiary. Resolution of this puzzlement is not required to decide the present motions.

Appendix D

PLAINTIFF'S LEGAL THEORY AND MOVANTS' CHALLENGES

Plaintiff claims that these transactions, when integrated, constitute violations of section 17(a) of the 1933 Act, 15 U.S.C. §77q(a) because all of the defendants, by their respective participation, employed a device, scheme and artifice to defraud Manhattan. The precise applicability of section 17(a) is never articulated in the complaint. Nevertheless, plaintiff's apparent position is that the bootstrap acquisition of control by Begole, Sweeny and Bourne whereby Manhattan's assets rather than outside funds were the source of the purchase price of Manhattan's shares was fraudulent insofar as Manhattan was concerned. Moreover, in order to retain control of Manhattan without disclosing the means of financing the acquisition of the Manhattan shares, defendants, as part of the same scheme, finagled records and executed intricate financial transactions to conceal and suppress the truth.

Bankers Life and the two Belgian American banks have moved to test the legal sufficiency of this theory as applied to the facts alleged in the complaint. More particularly, these defendants seek an order, pursuant to Fed. R. Civ. P. 12(c), (h), granting judgment on the pleadings and dismissing the complaint as to them on the grounds that the Court lacks federal question or diversity jurisdiction; that plaintiff lacks standing to recover damages for violations of section 17(a) of the 1933 Act; and that the complaint fails to state a claim upon which relief can be granted.

In the context of complaints alleging violations of the securities acts, there is no significant distinction between dismissal for lack of jurisdiction and dismissal for failure to state a cause of action. Federal jurisdiction depends on the existence of a federal question, *i.e.*, the violation of a

provision of one of the securities acts. Should the Court determine that the facts alleged do not make out a violation of federal law, and consequently fails to state a claim, the Court, in effect, has also determined that there is no federal question, and thus no jurisdiction. *See Britt* v. *Cyril Bath Co.*, 290 F.Supp. 934 (N.D.Ohio 1968). Therefore, the Court will not attempt, as a matter of formal analysis, to deal separately with these two grounds. Because the same issues of law are raised by both grounds, they will be discussed simultaneously.

The Court initially, however, directs its attention to the question of standing which can be decided without reference to the merits of the claim since this attack on the complaint assumes *arguendo* that it does allege an actual violation of the securities acts and that the Court has jurisdiction.

Who May Recover for Alleged Violations of the Anti-Fraud Provisions of the Securities Acts?

Defendants, in their memoranda, claim that plaintiff may not recover for violations of section 17(a) of the 1933 Act because that section gives rise to a cause of action in a defrauded purchaser only, and that it is obvious from the face of the complaint that Manhattan was not a purchaser of its own stock. At oral argument and in its briefs, plaintiff presents a number of arguments in refutation.

Plaintiff's position is that, for purposes of these motions, it is not limited to section 17(a) of the 1933 Act (the only section explicitly alleged to have been violated) but that it is entitled to have the motions denied if it has standing and if it makes out a claim under *any* federal statute.

Plaintiff then asserts that section 10(b) of the 1934 Act, 15 U.S.C. §78j(b) (1964) and S.E.C. Rule 10b-5 are also material; that the complaint does state a cause of action under that section; and that plaintiff has standing to sue for damages resulting from violations of section 10(b) of the 1934 Act and section 17(a) of the 1933 Act.

The Court is not restricted to the particular legal theory of recovery or jurisdictional basis alleged in the complaint. If the facts are alleged with reasonable clarity so as to give adequate notice of the transaction, and if plaintiff is entitled to recover under any legal theory, the complaint is sufficient. 1A Barron & Holtzoff, Federal Practice and Procedure §276.1 (Wright ed. 1960); 2A J. Moore, Federal Practice ¶8.14 (2d ed. 1968).

Moreover, because the operative language of section 10(b) and Rule 10b-5 is so similar to that of section 17(a) of the 1933 Act, the Court will consider the applicability of these provisions. *See Hoover* v. *Allen*, 241 F.Supp. 213, 226 n.7 (S.D.N.Y. 1965).

Only a defrauded purchaser may recover under section 17(a) of the 1933 Act. The statute provides:

> "It shall be unlawful for any person in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce or by use of the mails, directly or indirectly—
>
> (1) to employ any device, scheme or artifice to defraud, or
>
> (2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the

statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

This statute was aimed at fraudulent practices by which sellers of securities could defraud or deceive purchasers. The very purpose of the promulgation of Rule 10b-5 under the 1934 Act was to prohibit individuals or companies from buying securities if they engage in fraud in their purchase. The objective of Rule 10b-5 was to make the same prohibitions contained in section 17(a) of the 1933 Act applicable to purchasers as well as to sellers. *See, e.g., Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461, 463 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952); III L. Loss, Securities Regulation at 1423-30 (2d ed. 1961); A. Bromberg, Securities Law: Fraud at 19-20 (1968).

The requirement of being a defrauded purchaser to recover for a violation of section 17(a) has even more recently been upheld. *See, e.g., Schoenbaum* v. *Firstbrook*, 268 F.Supp. 385, 396 (S.D.N.Y. 1967), *aff'd*, 405 F.2d 200 (2d Cir.), *rev'd on other grounds en banc*, 405 F.2d 215 (2d Cir. 1968); *Colonial Realty Corp.* v. *The Curtis Publishing Co.*, CCH Fed. Sec. L. Rep. ¶92, 105 (S.D.N.Y. 1967); *cf. Hoover* v. *Allen*, 241 F.Supp. 213, 223 (S.D.N.Y. 1965).

Rule 10b-5, however, is more expansive than section 17(a) of the 1933 Act. It prohibits fraud or deception by either a purchaser or seller; and its operative language is "in connection with the purchase or sale of any security" as distinguished from the phrase "in the offer or sale of

any securities" which appears in Section 17(a) of the 1933 Act.[10] Nevertheless, the standing requirement appears to differ only in that defrauded sellers as well as purchasers are included in the permissible class of potential plaintiffs.

In *Birnbaum* v. *Newport Steel Corp.*, 193 F.2d 461 (2d Cir.), *cert. denied*, 343 U.S. 956 (1952), plaintiff sought to prosecute a derivative suit against the former president and major shareholder of the corporation who allegedly had violated section 10(b) and Rule 10b-5 in rejecting, as

---

[10] The texts of section 10(b) and Rule 10b-5 are hereafter set forth:

"Section 10. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

* * * * *

(b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors."

"Rule 10b-5. Employment of Manipulative and Deceptive Devices.

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,

(1) to employ any device, scheme, or artifice to defraud,

(2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

(3) to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security."

president, an allegedly favorable merger offer and who then sold his stock to another company at a substantial premium. In affirming the district court's dismissal of the complaint, the court, *inter alia,* held that the action could not be maintained in the corporate name in the absence of an allegation that the plaintiff corporation was either a defrauded purchaser or seller of securities. This holding has been consistently applied. *See, e.g., Chasin* v. *Mencher,* 255 F.Supp. 545, 548 (S.D.N.Y. 1965) and cases there cited.

Plaintiff contends that *Birnbaum* is no longer controlling doctrine. It argues that recent case law (mostly developed by the Second Circuit) has eroded the validity of *Birnbaum* and the limitation of standing to defrauded purchasers or sellers.

The Court rejects plaintiff's reading of recent decisions. Though there have been, literally, dozens of cases raising the issue since *Birnbaum,* not one has permitted a plaintiff who has been held to be other than a "purchaser or seller" (as those terms have been interpreted) to maintain an action for damages under Rule 10b-5.

In *Hooper* v. *Mountain States Securities Corp.,* 282 F.2d 195 (5th Cir. 1960), a case much relied on by plaintiff, the court did permit the trustee in bankruptcy to sue in behalf of a corporation whose stock had been issued, without registration, and then publicly distributed by some of the defendants. Plaintiff alleged a violation of Rule 10b-5 in that the corporation's transfer agent was induced to issue these shares on the basis of fraudulent representations made to the agent by former officers of the bankrupt. The court held that the corporation could maintain its action for the reason that the issuance of stock was a "sale" and since it did not receive full consideration for the valuable shares issued, the corporation was thus a defrauded "seller."

Hooper, thus, manifestly does not indicate the demise of the purchaser-seller requirement.

Hooper did serve as the genesis for a long string of cases that have permitted corporations to sue for damages when they were the victim of a securities fraud. Yet, in every case, the corporation either qualified as a "seller" since it had issued new shares, or as a purchaser when it redeemed shares or purchased treasury stock.

Other cases are also relied upon by plaintiff to support its thesis that the authority of *Birnbaum* has become attenuated. *Ruckle* v. *Roto American Corporation*, 339 F.2d 24 (2d Cir. 1964), upheld the right of a defrauded *issuer* to recover damages because preventing the perpetration of fraud upon an issuer with the consequent distribution of newly issued and watered stock was one of the chief reasons for the enactment of the securities laws. 339 F.2d at 28. Since an "issuer" is a seller (per *Hooper*), this result is not inconsistent with the *Birnbaum* purchaser-seller requirement. And, although *Ruckle* distinguished *Birnbaum* and *Howard* v. *Furst*[11] on the grounds that the corporations in those cases had not sustained injury, it is clear from the rationale for the *Ruckle* decision that the mere existence of corporate injury was not the crucial, decisive factor; the emphasis was on the spread of overvalued securities resulting from the fraud on the corporation.

Nor do the other cases cited by plaintiff support its *Birnbaum* erosion thesis. In *Vine* v. *Beneficial Finance Co.*, 374 F.2d 627 (2d Cir. 1967), the court held that a minority shareholder who, pursuant to a short form statutory merger, was forced either to sell his shares to the surviving corporation or to retain shares in a defunct corporation was

[11] 23 F.2d 790 (2d Cir. 1956), *cert. denied*, 353 U.S. 937 (1957) (shareholders may not sue derivatively for injury growing out of S.E.C. proxy rule violations).

a "seller", though he retained his shares. The court specifically disclaimed any intention to depart from the traditional purchaser-seller requirement and decided that, under the particular circumstances, plaintiff was, as a practical matter, a seller.

In *A.T. Brod & Co.* v. *Perlow*, 375 F.2d 393 (2d Cir. 1967), the court reversed the dismissal of a complaint which charged that defendant had employed a scheme in refusing to pay for securities he had ordered from plaintiff-broker. The court noted, explicitly, that plaintiff in that case was a purchaser and thus there was no need to delve into the question of whether a broader standing requirement should be adopted. 375 F.2d at 397 n. 3.

It is true that *Brod* implicitly criticized *Birnbaum* in the statement: "Nor do we think it sound to dismiss a complaint merely because the alleged scheme does not involve the type of fraud that is 'usually associated with the sale or purchase of securities'. We believe that §10(b) and Rule 10b-5 prohibit *all* fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception." 375 F.2d at 397. The language the Court of Appeals believed too limited is that of *Birnbaum*.

An analysis of the decision in *Birnbaum*, however, discloses that there were at least two distinct reasons for dismissing the complaint[12]—the failure of the allegations to state a cause of action, and the lack of standing in the corporation to recover for violations of the securities laws when the corporation was neither a defrauded purchaser nor defrauded seller. The language quoted by *Brod* was

[12] One commentator has also noted the tendency to confuse the distinct grounds for decision in *Birnbaum* which results from "an uncritical reading of the general language . . ." *See* A. Bromberg, *supra* at 88.1.

the *Birnbaum* court's rationale for dismissal for failure to state a claim; so too, the only issue involved in *Brod* was the question of whether the facts alleged constituted a violation of Rule 10b-5. And thus, while *Brod* must be read as modifying *Birnbaum* on this issue, *Birnbaum's* standing requirements have not been altered.[13]

---

[13] Though not cited by plaintiff to this Court, two other cases have been relied on as authority for the *Birnbaum* "erosion" or "demise" theory. *See* Lowenfels, *The Demise of the Birnbaum Doctrine: A New Era For Rule 10b-5*, 54 Va. L. Rev. 268 (1968). In *Symington Wayne Corp.* v. *Dresser Industries, Inc.*, 383 F.2d 840 (2d Cir. 1967), the court denied, on the grounds of failure to prove irreparable harm, an application for an order enjoining a tender offer allegedly steeped in material misrepresentations and omissions. Though the court reached the merits in a suit brought by the corporation being acquired and two of its shareholders, it specifically refrained from deciding the question of standing. 383 F.2d at 842. In *Mutual Shares* v. *Genesco*, 384 F.2d 540 (2d Cir. 1967), the court did decide that one need not be a purchaser or seller in a suit for an injunction, but held, however, that the trial court's dismissal of the damages claim was correct. *See* 384 F.2d at 547. The injunction was against a continuing deceitful manipulation of the market price of publicly-owned stock; and this conduct was held to create a claim under section 10(b) and Rule 10b-5. The Court explicitly stated that the claim for equitable relief required proof of fewer elements than would a claim for damages.

Lowenfels, *supra*, does not distinguish between the two separate grounds for decision in *Birnbaum;* and thus fails to note that *Brod* modifies *Birnbaum* only with respect to the ground based on failure to state a claim.

Weitzen v. *Kearns*, 271 F.Supp. 616, 622 (S.D.N.Y. 1967), and *Entel* v. *Allen*, 270 F.Supp. 60, 69 (S.D.N.Y. 1967)—both decided by the same judge—apparently also came to the conclusion that *Birnbaum* was "seriously challenged, if not overruled" by reading *Brod* as questioning *Birnbaum's* holding with respect to standing as well as the scope of Rule 10b-5. However, in *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968), the Second Circuit squarely reaffirmed the continuing validity of *Birnbaum* as authority for the rule that to maintain an action for damages under section 10(b) and Rule 10b-5 the plaintiff must have been a seller of the stock involved. *See also Christophides* v. *Porco*, 289 F.Supp. 403 (S.D. N.Y. 1968); *Bound Brook Water Co.* v. *Jaffe*, 284 F.Sup. 702 (D.N.J. 1968).

Indeed, in *Greenstein* v. *Paul*, 400 F.2d 580 (2d Cir. 1968), the Court of Appeals appeared to foreclose any argument respecting the demise of the *Birnbaum* purchaser-seller requirement:

> "It has long been the rule in this circuit that to maintain an action under §10(b) of the [1934] Act and Rule 10b-5 of the Securities and Exchange Commission the plaintiff must have been a seller of the stock involved. Birnbaum v. Newport Steel Corp., 193 F.2d 461 (C.A. 2, 1952), cert. denied 343 U.S. 956 (1952). Although criticized, Entel v. Allen, 270 F.Supp. 60, 70 (S.D.N.Y., 1967), it is still the rule at least insofar as actions for damages are concerned. Mutual Shares Corp. v. Genesco, Inc., supra."

EXPANSION OF THE PURCHASER-SELLER REQUIREMENT?

Plaintiff argues that, even if the purchaser-seller requirement has not yet been expressly overruled or broadened, the various cases which were cited by plaintiff for that proposition, and discussed by the Court above, at least indicate discontent with the narrow *Birnbaum* rule, forcing the Court of Appeals to choose other means to circumvent its rigors (*e.g.*, interpreting term "seller" broadly). Plaintiff thus appears to ask this Court to broaden, in an explicit fashion, the standing requirements. Plaintiff refers the Court to the brief of the Securities and Exchange Commission as *amicus curiae* in *Vine* v. *Beneficial Finance Co.*, *supra*, where the S.E.C. argued for such an expansion. Plaintiff argues that this step would eliminate unnecessary complexities, distinctions, and incentives to clever scheming and would achieve greater justice in the individual case. Memorandum of Plantiff In Opposition to Motions Pur-

suant to Rules 12(c) and 12(h) Federal Rules of Civil Procedure at 31.

Other reasons have been advanced by commentators for the abandonment of the purchaser-seller prerequisite. *See, e.g.*, Lowenfels, *supra* note 12; Note, *The Purchaser-Seller Rule: An Archaic Tool for Determining Standing Under Rule 10b-5*, 56 Geo. L.J. 1177 (1968).

The rule that this Court is asked to adopt is that anyone who is injured by a violation of the securities acts may sue to recover damages. The Court declines this invitation to expand the traditional standing requirement.

The Court of Appeals has declined to accede to the repeated requests of plaintiffs and *amici curiae* to enlarge the class of potential plaintiffs in actions for damages arising out of violations of Rule 10b-5. In the light of *Greenstein* v. *Paul, supra*, the Court does not discern any imminent doctrinal change by the Court of Appeals. In these circumstances, a district judge may not disregard an established principle of law. Accordingly, the Court rules that only a defrauded purchaser or seller may sue for damages arising from a violation of section 10(b) of the 1934 Act and S.E.C. Rule 10b-5.

Is Plaintiff a Defrauded Purchaser or Seller of Securities?

The complaint charges a violation of the anti-fraud provisions of the 1933 Act in the purchase and sale of the shares of Manhattan stock on January 24, 1962. (¶¶1, 18, 40). The seller of these shares was Bankers Life and the purchaser was Begole. (¶20). From the face of the pleadings, it thus appears that plaintiff—Manhattan—was neither a purchaser nor a seller of the security (shares of Manhattan stock) which was the subject of the alleged fraud.

At oral argument, however, plaintiff's counsel suggested that—in view of the fact that Begole did not furnish any "fresh" consideration for the purchase of the shares and that, ultimately, it was Manhattan's funds which paid for the shares—Manhattan should be considered the purchaser. (Tr. at 30). While it is true that a corporation can be a purchaser of its own stock within the meaning of the securities laws, *see, e.g., O'Neill* v. *Maytag*, 230 F.Supp. 235 (S.D.N.Y.), *aff'd*, 339 F.2d 764 (2d Cir. 1964), a corporation cannot be the purchaser of *all* of its own stock unless the shares were cancelled and a general dissolution occurred. This is so because a corporation cannot maintain its status as a separate or existing entity (or fictional person) without having another entity or individual serve in the capacity of proprietor or owner.

This Court deems, as a matter of law, the fact that plaintiff may have been the ultimate source of funds for the purchase of Manhattan shares (*i.e.*, the proceeds of the sale of Manhattan's portfolio of United States Government securities were received by Irving Trust Company and credited to Manhattan's account, which thereafter was charged with the $5,000,000 check delivered by Irving Trust Company to Bankers Life) insufficient to establish plaintiff as the purchaser of Manhattan shares because it was never intended that plaintiff would take title to those shares. This Court holds that, insofar as section 17(a) of the 1933 Act and section 10(b) of the 1934 Act are concerned, a purchaser of securities is one who was a party to a transaction whereby he was to assume ownership of securities in exchange for valuable consideration. Under this definition, plaintiff fails to achieve the status of purchaser and, consequently, may not assert a cause of action for a violation

of the securities laws with respect to the purchase and sale of the Manhattan shares.

Though the complaint alleges fraud only in the purchase and sale of the Manhattan shares, plaintiff now adopts the new position that, as a purchaser of a certificate of deposit, and as a seller of United States Government securities, plaintiff has standing to sue in this action (Tr. at 32-35).

Without commenting on the propriety of ruling on the sufficiency of a complaint based on amendatory allegations presented in open court and not formally set forth in the complaint, the Court concludes that if, within the meaning of the securities acts, fraudulent schemes were employed in connection with the sale of Manhattan's portfolio of United States Government securities, plaintiff, *if damaged,* may maintain a suit to recover. Manhattan was a seller of those securities, though management perhaps breached its duties to the corporation in authorizing or ratifying the sale; and, if the corporation was damaged through fraudulent activities, plaintiff may recover damages.

With respect to plaintiff's standing deriving from its alleged "purchase" of various certificates of deposit,[14] the Court is convinced that plaintiff was not a purchaser, despite the fact that it tendered to Belgian American Trust, Irving Trust Company's check for $5,000,000 and received a $5,000,000 certificate of deposit payable to itself. Since, by prearrangement, this certificate was endorsed to New England Note Corporation which delivered it to Belgian

[14] The Court's discussion of purchases of certificates of deposit does not refer to the $500,000 First National Bank of Boston certificate of deposit, regarding which the complaint is generally devoid of information. From the facts alleged, it does not appear that any fraudulent act was practiced relative to this certificate, and thus the question of standing is irrelevant.

Appendix D

American Banking as collateral for the $5,000,000 loan from Belgian American Banking to New England Note Corporation, and the proceeds of this loan were given directly to Irving Trust Company in payment for the $5,000,000 check that had paid for the certificate of deposit, this entire transaction was a "wash" and had no economic reality. As such, Manhattan was not a "purchaser" of a "security" but was merely participating as a conduit for the sole purpose of having its name appear as payee which enabled the fraud to become further camouflaged.

The Court is mindful of the argument that Manhattan's portfolio of United States Government securities was the ultimate source of funds for financing all the transactions in the three certificates of deposit and that the misappropriation of the proceeds of the sale of Manhattan's portfolio constituted the fraud. What is of controlling importance is that the facts as pleaded do not portray Manhattan as the purchaser of the two Belgian American Trust certificates of deposit. Neither Manhattan's portfolio nor the proceeds thereof was the immediate consideration for the issuance of these two certificates.

Nor was Manhattan a purchaser of the third certificate of deposit,—the Irving Trust Company $5,500,000 certificate of deposit which was paid for by the proceeds of the Marine Midland $5,500,000 loan to Garvin, Bantel. Garvin, Bantel and Irving Trust Company were the only parties to the transaction whereby this certificate was issued, although Manhattan was the payee of the certificate. Garvin, Bantel, as previously noted, received physical delivery of the certificate and presumably used this certificate of deposit as collateral for the $5,500,000 loan which initially furnished the consideration for the issuance of the certificate.

Therefore, the Court need not reach the novel and difficult question of whether certificates of deposit of this nature fall within the statutory definition of the term "security".[14a]

[14a] Section 2(1) of the 1933 Act, 15 U.S.C. §77b(1) (1964), defines the term "security" for the purpose of that act to include "any note, stock, treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a 'security', or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing."

Section 3(a)(10) of the 1934 Act, 15 U.S.C. §78c(a)(10) (1964), sets forth the meaning of the term "security" for the purpose of that act:

> "The term 'security' means any note, stock, treasury stock, bond, debenture, certificate of interest or participation in any profit-sharing agreement or in any oil, gas, or other mineral royalty or lease, any collateral-trust certificate, preorganization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit, for a security, or in general, any instrument commonly known as a 'security'; or any certificate of interest or participation in, temporary or interim certificate for, receipt for, or warrant or right to subscribe to or purchase, any of the foregoing; but shall not include currency or any note, draft, bill of exchange, or banker's acceptance which has a maturity at the time of issuance of not exceeding nine months, exclusive of days of grace, or any renewal thereof the maturity of which is likewise limited."

The certificates of deposit in this case were not issued for a security—they were issued for cash and are pieces of paper "evidencing the existence of a time deposit." *S.E.C.* v. *Fifth Avenue Coach Lines, Inc.*, 289 F.Supp. 3, 31 (S.D.N.Y. 1968). Thus, they would not be deemed "securities" as a species of the class of instruments designated in the statute as "certificate of deposit for a security."

The S.E.C., however, has taken the position that the anti-fraud provisions of the securities acts apply to deposit and share ac-

Appendix D

Does the Complaint Allege Facts Constituting A Violation of the Securities Acts?

The Court has expressed its conclusion that plaintiff lacks standing to maintain an action for fraud in connection with the purchase or sale of the Manhattan shares and the three certificates of deposit. Were the Court to follow the consequences of this legal conclusion as to standing, it would be unnecessary for the Court to decide the question of whether the acts charged in the complaint with respect to these particular transactions constitute violations of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act.

However, as the Court has also concluded, plaintiff does have standing to maintain an action alleging fraud in connection with the sale of Manhattan's portfolio of United

---

counts in national banks. *See* 31 Fed. Reg. 16, 581, *reprinted in* CCH Fed. Sec. L. Rep. ¶77,421 (1966-67 Transfer Binder).

The Supreme Court, in *Tcherepnin* v. *Knight*, 389 U.S. 332 (1967), held that withdrawable capital shares in a state-chartered savings and loan association were "investment contracts" and, consequently, constituted "securities" under the 1934 Act. The Court noted that the term "security" " 'embodies a flexible rather than static principle . . .' " 389 U.S. at 338.

Giving the definition of "security" this liberal reading, a certificate of deposit issued for cash by a bank could be considered the equivalent of an "evidence of indebtedness" and would be a "security" within the meaning of the 1933 Act.

The 1934 Act, however, does not include the term "evidence of indebtedness" in the statutory definition. Conceivably, a certificate of deposit issued for cash by a bank might be deemed an "investment contract" or more likely a "note". But the specific exclusion of "any note, draft, bill of exchange, or banker's acceptance" having a maturity of nine months or less from the definition under the 1934 Act, would appear applicable to a six-months' certificate of deposit issued for cash by a bank and which evidences a time deposit made at the issuing bank.

States Goverment securities. Consequently, the Court must consider whether the acts charged in the complaint constitute violations of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act with respect to that particular security transaction.

Plaintiff contends that there was but one pervasive fraudulent scheme, and that all of the various security transactions and other financial manoeuvres were interrelated and cumulative. Since the Court must, for present purposes, accept the allegations of the complaint as true, the Court will determine whether the complaint, considered as a whole, charges conduct which violates section 17(a) of the 1933 Act or section 10(b) of the 1934 Act. Therefore, the Court's discussion will be directed to the complaint as a whole and be general in terms. The Court holds that the allegations of fraud in connection with the sale of Manhattan's portfolio of United States Government securities do not charge conduct violative of the securities acts. The rationale underlying that holding applies equally to the allegations of fraud in connection with the purchase and sale of the Manhattan shares, that is, such allegations do not charge conduct violative of the securities acts. Similarly, if it be assumed that the three certificates of deposit herein constitute "securities" within the meaning of the securities acts, such rationale demonstrates that the allegations of fraud in connection with the purchase of said certificates of deposit do not charge conduct violative of the securities acts.

The gravamen of the complaint is the diminution in Manhattan's assets. This diversion or misappropriation of assets apparently was the essence of the fraud. The allegations describing subsequent conduct charge only that they were designed to conceal the defendants' misdeeds in a maze of numerous intricate and confusing transactions.

Appendix D

A viable claim under Rule 10b-5[15] requires that there have been fraud or deception in connection with the purchase or sale of securities. In interpreting the phrase "in connection with the purchase or sale of any security," it would be relevant to discuss the purpose of the Congressional enactment, and, in so doing, to consider whether the alleged fraud could result in the abuses sought to be curbed or prevented and whether the fraudulent activity otherwise touched on any federal concern.

The securities acts, and especially the 1934 Act, were intended to prevent fraud and deception, manipulation and inadequate disclosure in the dissemination and trading of securities. The securities acts are not so much concerned with fraud *per se* as with the effect of fraud upon investors and the public interest in maintaining free and open securities markets. 1934 Act §2(3), 15 U.S.C. §78b(3); *Schoenbaum* v. *Firstbrook,* 405 F.2d 200, 212 (2d Cir.), *rev'd en banc,* 405 F.2d 215 (2d Cir. 1968); *S.E.C.* v. *Texas Gulf Sulphur Co.,* 401 F.2d 833, 858-60 (2d Cir., *en banc,* 1968); *cf. A.T. Brod & Co.* v. *Perlow, supra.*

In order to sustain a complaint alleging fraud under section 10(b) of the 1934 Act, it must appear with reasonable clarity from the face of the complaint either (1) that a purchase or sale of securities is at the crux of a fraudulent scheme; or (2) that inducing a purchase or sale of securities is the object of a fraudulent scheme; or (3) that fraudulent statements, misstatements, or omissions are made in a manner which is reasonably calculated to in-

[15] On the premise that the more liberal language of Rule 10b-5 is an indication that its scope is more expansive than that of section 17(a) of the 1933 Act, the Court will discuss this issue only in terms of Rule 10b-5. If no claim is established under Rule 10b-5, *a fortiori,* none would exist under section 17(a) of the 1933 Act.

fluence the investing public, or are of the sort which the reasonable investing public might rely upon; or (4) that the trading process is abused through potential market manipulation or the spread of watered stock.

The purity of the security transaction and the purity of the trading process are the sole objectives of federal concern. Therefore, the consummation of a security transaction as a mere incident of a fraudulent scheme and the mere fact of injury caused by the fraud, in the absence of any possibility that the fraud might materially affect the purity of the security transaction and the purity of the trading process would not make the fraud federally cognizable. *Cf. O'Neill* v. *Maytag*, 230 F.Supp. 235, 239 (S.D. N.Y.), *aff'd*, 339 F.2d 764 (2d Cir. 1964).

Giving the unique factual allegations of the complaint a most liberal reading, the Court concludes that plaintiff was not the victim of "federal fraud" as defined above.[16] A

[16] The Court also declines to sustain the sufficiency of the complaint because the injury in this particular case (and thus the benefit of any recovery) was not incurred by anyone who was the subject of federal concern. In view of the unusual fact that the fraud was practiced not upon any member of the "decision-making body" of the corporation (*i.e.*, officers, directors, or shareholders), *see Globus, Inc.* v. *Jaroff*, 266 F.Supp. 524, 529 (S.D.N.Y. 1967); *Simon* v. *New Haven Board & Carton Co.*, 250 F.Supp. 297, 299 (D. Conn. 1966), but only upon creditors and policy holders, it is dubious whether plaintiff corporation was ever defrauded or deceived.

Doubtless, a corporation may be deceived or defrauded even if every member of the board of directors was fully informed of the true facts (or, in factual situations similar to this case, that all of the directors were participants in the scheme). *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir. *en banc*, 1968); *Continental Bank & Trust Co.* v. *Garfinkle*, 292 F.Supp. 709 (S.D.N.Y. 1968). But, as is evident from Judge Hays' dissenting opinion in the three-judge panel decision in *Schoenbaum* v. *Firstbrook*, *supra* (Judge Hays, significantly, having also authored the *en banc* majority opinion reversing the three-judge panel's decision), in

federal claim is not pleaded by allegations that, in the course of a scheme to loot a corporation of its assets, certain security transactions occurred, when these transactions—though contaminated by the overriding evil intent to accomplish the ultimate looting—did not involve fraud or deceit in connection with the sale or purchase of a security.

Manifestly, the sale of Manhattan's portfolio and the purchase of the Manhattan shares were necessary steps toward the ultimate looting of Manhattan's assets. But Rule 10b-5 requires the employment of fraud in connection with a security transaction, which is essentially different from the effectuation of a security transaction in connection with a fraudulent activity.[16a]

---

such a case, there must be a showing that the directors deceived the shareholders—"the real owners of the property with which the directors were dealing." 405 F.2d at 215.

The highly individualized circumstance present in the case at bar—the lack of injury to shareholders—intensifies the Court's reluctance to hold that the complaint states a claim of federal fraud.

[16a] The distinction here drawn can be best illustrated by analogy to the general conspiracy statute, 18 U.S.C. §371 (1964), which makes unlawful a conspiracy when one or more of the members of the conspiracy "do any act to effect the object of the conspiracy." In order for conduct to qualify as an overt act under that statute, the conduct need not, of itself, be unlawful, provided it was done to effect the object of the conspiracy. Nevertheless, unless the act done in furtherance of the conspiracy was itself unlawful, although committed for the purpose of furthering the object of the conspiracy, the overt act may not serve as the basis for a criminal prosecution for a substantive crime.

Similarly, in this case, the various security transactions were overt acts committed for the purpose of promoting and effecting the object of the fraudulent conspiracy (*e.g.*, the sale of Manhattan's portfolio of United States Government securities was necessary to effectuate the looting of Manhattan's assets). However, unless such security transactions were independently unlawful—

Appendix D

The complaint, taken as a whole, alleges no more than a common law action for misappropriation of corporate funds by a fiduciary, embezzlement or fraudulent conveyance perhaps, or the distribution of an illegal dividend. None of these actions, in the absence of diversity of citizenship, can be maintained in a federal court.

Ruckle v. *Roto American Corp.*, 339 F.2d 24 (2d Cir. 1964) and *Schoenbaum* v. *Firstbrook*, 405 F.2d 215 (2d Cir., *en banc*, 1968) do not hold otherwise. In *Ruckle*, the corporation proposed to issue its own shares to the president for a less than adequate consideration. A majority of the board withheld material information from one of the directors before approval was voted. The court held that the issuance would constitute a violation of Rule 10b-5.

In *Schoenbaum*, the court held that the issuance of stock by a corporation to its controlling stockholder at "vastly inadequate prices," apparently with each board member having full knowledge of the inadequacies (all were named as co-conspirators and defendants), stated a claim for relief under section 10(b) and Rule 10b-5.

The crucial facts in these cases were that, in each, the "fraudulent practice" was deception (whether of directors or shareholders) which directly resulted in the issuance of stock for inadequate consideration, thus, creating the danger of the spread of "thin" or "watered" stock. The direct involvement of the deceit with a transaction of securities

---

i.e., unless there was fraud in connection with the purchase or sale of a security—they could not serve as the basis for a substantive claim under section 10(b) and Rule 10b-5. As pleaded, the security transactions themselves, when considered from the viewpoint of section 10(b) and Rule 10b-5, were innocuous though constituting overt acts furthering the fraudulent scheme. Consequently, they cannot serve as the independent predicate for liability under section 10(b) and Rule 10b-5.

is fraud "in connection with" the sale of stock, and, consequently, constitutes federal fraud irrespective of whether it also constitutes corporate mismanagement. As the three-judge panel in *Schoenbaum* v. *Firstbrook, supra,* stated: "A fraud upon a corporation which has the effect of depriving it of fair consideration for the issuance of its stock would necessarily have the effect of reducing the equity of the corporation's shareholders and this reduction in equity would be reflected in lower prices bid for the shares on the domestic stock market." 405 F.2d at 208.

The facts in the instant case, on the contrary, could not give rise to any of these dangers and do not evidence that the fraud was rooted in a security transaction.

That the complaint in this case states no more than a non-federal common law cause of action becomes even more evident upon consideration of the factual situation and language of the Court of Appeals in *Mutual Shares Corp.* v. *Genesco, Inc.,* 384 F.2d 540 (2d Cir. 1967). Plaintiffs there alleged, *inter alia,* that defendant Genesco, a 94% stockholder in S.H. Kress & Co. had acquired its shares pursuant to a fraudulent conspiracy, the purpose of which was to finance its purchases of Kress stock from Kress' own assets and to manage Kress for Genesco's own benefit, appropriating Kress' assets in the meanwhile. After holding that plaintiffs could not maintain an action charging violations of Rule 10b-5 occurring before plaintiffs had acquired their shares, the court stated (as to the period subsequent to plaintiffs' acquisition of shareholder status) that the "fraudulent activities then alleged are primarily corporate abuse and diversion, claims cognizable under state law but not under the Act." 384 F.2d at 546. Only the claim that defendants had "manipulated the market price

of Kress stock, keeping dividends to a minimum, in order to force minority shareholders to sell out to Genesco at depressed values," *id.*, stated a good cause of action under Rule 10b-5.

The complaint in this case also fails to allege any actual or potential abuse of the trading process. Since public distributon of watered or valueless stock was not a part of the scheme, and the fraud had no potential manipulative effect on the market, and did not raise the spectre of any other evil which prompted passage of the securities acts or is a subject of federal concern, the factual situation in the instant case differs significantly from those in the cases plaintiff cites as major support for sustaining the validity of its claim.

A.T. Brod & Co. v. *Perlow; supra,* explicitly found that the fraud was federally cognizable because it had a "potentially manipulative effect on the securities market." 375 F.2nd at 397.

Hooper v. *Mountain State Securities Corp.*, 282 F.2d 195 (5th Cir. 1960), *cert. denied,* 365 U.S. 814 (1961), is also stressed heavily by plaintiff. In that case, an individual named Cage was required to sever his connection with the plaintiff corporation (the nominal plaintiff was the corporation's trustee in bankruptcy) when a new group acquired control. Cage concocted a scheme whereby he induced the plaintiff's transfer agent to issue new shares with a market value of about $700,000 after transferring to the corporation worthless contract rights. The actual fraud appeared to be the false representations made to the transfer agent by certain former officers of the corporation and the phony corporate documents prepared to justify and legitimize the issuance of stock. The scheme also involved

the distribution by Cage and his cohorts of this newly issued stock over security markets to unwary members of the investing public. Because the purpose and object of the scheme were to have valuable corporate stock issued to Cage (actually to another corporation controlled by Cage which was liquidated immediately after receiving the stock) in exchange for worthless consideration, and then to distribute the stock publicly, the fraud was definitely "in connection with" the purchase and sale of securities. The scheme induced an unfair sale of securities and it had as a major purpose the spread of watered stock to many investors.

In *Pettit* v. *The American Stock Exchange,* 217 F.Supp. 21 (S.D.N.Y. 1963), a similar scheme was perpetrated when huge amounts of Swan-Finch stock was issued, through various corporate shells, for worthless consideration, and then distributed over the American Stock Exchange. That court noted that the fraud violated Rule 10b-5 because the transaction represented an "abuse of the securities trading process," and because the "heart of this case are two fraudulent transactions in securities." 217 F.Supp. at 25-26.

Each security transaction herein was effected for full and fair consideration with full knowledge in both purchaser and seller as to the value of the securities sold. Where this has occurred Rule 10b-5 is not violated. *See* Fleischer, *"Federal Corporation Law": An Assessment,* 78 Harv. L. Rev. 1146, 1166 (1965). Only where the security transaction was a "vital aspect of a continuing scheme," should the fact of subsequent misappropriation of the consideration result in a violation of Rule 10b-5. *Compare Cooper* v. *North Jersey Trust Co.,* 226 F.Supp. 972, 978 (S.D.N.Y. 1964), *with S.E.C.* v. *Fifth Avenue Coach Lines, Inc.,* 289 F.Supp. 3, 36-39 (S.D.N.Y. 1968).

Appendix D

The complaint in this case presents no more than a complicated scheme of common law fraud.[17]

Discovery herein has been extensive. The parties have not called to the Court's attention any facts which were not alleged in the complaint and which would, if leave to amend the complaint were granted, state a cause of action under the securities acts. Accordingly, the Court hereby dismisses the complaint as to the movants and hereby directs that judgment be entered for movants. Fed. R. Civ. P. 54(b).

Dated: New York, N. Y.
June 3, 1969.

/s/ WILLIAM B. HERLANDS
William B. Herlands
U.S.D.J.

---

[17] Plaintiff instituted such a common law action in New York County, Supreme Court in 1965. After joinder of issue, further proceedings in the action were enjoined. The factual allegations of the complaint filed in the state court proceeding are essentially the same as those contained in the complaint herein.

APPENDIX E

UNITED STATES DISTRICT COURT

FOR THE SOUTHERN DISTRICT OF NEW YORK

63 Civ. 3490—June 9, 1969

SUPERINTENDENT OF INSURANCE OF THE STATE OF NEW YORK, as Liquidator of Manhattan Casualty Company,

Plaintiff,

v.

BANKERS LIFE AND CASUALTY COMPANY, Irving Trust Company, Belgian American Banking Corporation, Belgian American Bank & Trust Company, Garvin, Bantel & Company, New England Note Corporation, George K. Garvin, John F. Sweeny, the Estate of Standish T. Bourne, by Standish T. Bourne, Jr., as Executor, the Estate of James F. Begole, by Patricia C. R. Begole, Executrix,

Defendants.

RYAN, District Judge:

Jurisdiction of the Court to entertain this action is now directly challenged in motions to dismiss made by defendant IRVING TRUST COMPANY and by defendants GARVIN, BANTEL & COMPANY and GEORGE K. GARVIN. (See our memorandum endorsement of June 19, 1968.)

Diversity jurisdiction is not present.

Plaintiff urges that, although the complaint alleges that jurisdiction over the subject matter is based on violations of Section 17A of the Securities Exchange Act of 1933 (15

.U.S.C. 77q(a)), jurisdiction also exists under Section 10(b) of the 1934 Act and S.E.C. Rule 10b-5.

Plaintiff was neither a defrauded purchaser nor seller, and he may not plead a claim under Section 10(b) of the 1934 Act and S.E.C. Rule 10b-5. Judge Herlands so held granting the Bankers Life motion to dismiss for lack of jurisdiction (See Judge Herlands' opinion of June 3, 1969). I agree.

The complaint does allege fraud in connection with the sale of Manhattan's U.S. Government securities. The fraud charges was not in violation of the Securities Acts of either 1933 or 1934. The fraud alleged was not in the purchase or sale of securities, but was waste of Manhattan's assets by diversion and misappropriation of its securities. I agree with Judge Herlands that "the complaint in this case presents no more than a complicated scheme of common law fraud" over which there is no independent federal jurisdiction.

Motions to dismiss are granted without prejudice to prosecution of the action plaintiff filed and is pending in the Supreme Court, County of New York. Settle appropriate order directing entry of such judgment.

Dated: June 9, 1969.

/s/ SYLVESTER J. RYAN
Sylvester J. Ryan
U.S.D.J.